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TECHNIQUES OF INVESTIGATION FOR ASSESSMENT

Vol 2

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INCOME TAX DEPARTMENT

TECHNIQUES OF INVESTIGATION FOR ASSESSMENT

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Vol. 2

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DIRECTORATE OF INCOME-TAX (PR, P&P)
6th Floor, Mayur Bhawan, Connaught Circus
New Delhi – 110001
Ph: 011-23413403, 23413317, 23411267
E-mail: delhi.ddit.pr@incometax.gov.in
www.incometaxindia.gov.in @IncomeTaxIndia

Publishing Consultancy
EXCEL INDIA PUBLISHERS
91 A, Ground Floor, Pratik Market, Munirka, New Delhi–110 067
Tel: +91-11-2671 1755/ 2755/ 3755/ 5755, Fax: +91-11-2671 6755
Cell: 9899127755, 9999609755, 9910757755
E-mail: publishing@groupexcelindia.com
www.groupexcelindia.com

Designed, Typeset and Printed by
Excel Printing Universe, New Delhi–110 067
E-mail: printing@groupexcelindia.com

सत्यमेव जयते
P. C. MODY
Chairman, CBDT &
Special Secretary to the Government of India

भारत सरकार
GOVERNMENT OF INDIA
(वित्त मंत्रालय / राजस्व विभाग)
Ministry of Finance/Department of Revenue
केन्द्रीय प्रत्यक्ष कर बोर्ड
Central Board of Direct Taxes
नार्थ ब्लॉक, नई दिल्ली - 110001
North Block, New Delhi - 110001
E-mail : chairmancbdt@nic.in
Tele : 23092648 & Telefax : 23092544

Foreword

As the financial ecosystem is evolving and changing rapidly, the tax authorities are required to keep themselves abreast with the latest developments in the field of tax investigations. There has been a seminal change in the way in which financial transactions are carried out. Owing to that, the methodology to track and analyse such transactions from the perspective of a tax investigator has also undergone a drastic change. In this backdrop, a need was felt to revise the existing *'Manual on Techniques of Investigation'*, which was last released in the year 2002.

The scope of the updated and revised Manual is to give the officers of the Income-tax Department an overview of the modern techniques of investigations. Two volumes of the revised Manual have been finalized. The chapters highlight the issues, legal position and techniques which the departmental officers can use to investigate the case and to tackle the tax evasion.

Volume – I deals with the topics discussed in the earlier edition and has been comprehensively revised and rewritten bearing in mind the latest developments. Specifically, the topic "Examination of book of accounts", has been redrafted keeping in view that the earlier system of manual book-keeping has been now replaced with maintenance of books of account over digital medium.

Volume – II of the Manual contains all new chapters and focuses on the contemporary aspects of tax investigations and deals with the issue involved in investigation of undisclosed foreign assets, transactions in commodity markets, money and currency markets, derivatives etc. It also deals with the latest technology for handling digital evidences, conducting forensic examination, the essential aspects of cryptocurrencies etc.

I would like to place on record my special appreciation for the efforts of all the members of the Committee and other officers associated with the mammoth task of rewriting this Manual. I hope, this Manual will act as a useful reference point for the officers of the department, while conducting inquiries and investigations.

(P.C. Mody)
Chairman and Member (Investigation)[i/c]
Central Board of Direct Taxes

New Delhi
Dated: 19/07/2019

Preface

The CBDT had undertaken a mammoth exercise of rewriting the departmental publication entitled 'Techniques of Investigation' and for this purpose a Committee was Committee on 27.11.2017. The need for the same had arisen from the fact that the earlier publication was more than 16 years old. Lot of water had flown down the Ganges, since then and new modern techniques of evasion are increasingly being adopted by the tax payers. The current series will enable the departmental officers to meet the challenges thrown by a more liberalized, privatized and globalized economy. The new series of 'Techniques of Investigation' is an effort to sensitize and educate the officers to effectively equip them with the requisite skill set.

The scope of the updated Manual is to give a bird's eye-view to the officers about the modern investigation techniques required by them for making sound assessment order. The compilation of the new series involves re-writing of the existing chapters, and introduction of several new chapters. The Volume 1 had dealt with, general issues arising in tax administration, investigation & examination of accounts for the purpose of drafting good assessment orders. However, the present Volume 2 of 'Techniques of Investigation' is unique on account of the fact that the chapters contained in it are new for the readers.

The various chapter of the compilation, at the outset gives a general over view of the subject, elucidates the prevalent method of tax evasion, gives tips for relevant investigation and enquiries, examines the legal jurisprudence on the issue and also follows up with relevant case studies. Though the discussion on judicial decisions and legal controversies had been avoided, as it is a dynamic and evolving area, however, discussion had been made about the correct legal frame work, wherever necessitated. The present publication had given a more holistic approach to the investigation of the most modern and latest modes of prevalent tax evasion issues.

In recent past, the methods of doing business have undergone a metamorphic change. With the advent of globalisation and the exposure to world class goods and services, small businesses have given way to large multinational corporations. Mergers and acquisitions of business and E-commerce is on the rise. In this changed environment, investigation for detecting tax evasion is challenging, but the fundamentals of investigation remains the same. Offenders are indulging in newer methods of tax evasion, while the older ones are also still alive in remote jurisdictions. While hawala transactions, bogus billing, benami transactions, etc continues, newer ways such as formation of shell corporations, violation of arm's length pricing, misuse of the concept of permanent establishment, dubious cross border transactions, shifting of profits to low tax jurisdiction etc. have surfaced as contemporary avenues of tax evasion. International taxation has emerged as a new field and would grow bigger considering the fact that India is a developing country and the Government is focusing on initiatives like Make in India, Digital India, etc.

Content wise, the present Volume provides an insight to Transfer Pricing and International Taxation issues with special emphasis on PE issues and comparability analysis. It had touched upon the latest legislations on Black Money, PMLA, GST etc. and the issues involved in investigation of undisclosed foreign assets. The most common methods of tax evasion by way of accommodation entries, penny stock, shell companies etc. have been dealt with, at length in the book. In view of the Information Technology revolution, a need had been felt to expose the officers to Digital Evidence and Forensic, Bitcoins and Cryptocurrencies, Forensic Investigation of E-mail dumps, Satellite Imagery etc.

The Chapters on I&CI, NCLT and Exchange of Information from foreign jurisdiction will equip our officers in a better manner for getting information from the right place and in a proper manner. The topics on Commodity Market, Money and Currency Market in India Derivatives, Future & Options had also been introduced for easy reference to the readers. The Flagship Scheme of the present Government *viz.* the "Operation Clean Money", also forms a part of the publication.

It is hoped that the material compiled here will provide necessary guidance and help to the Officers dealing with serious investigation cases, and will be a reference point for times to come.

The Committee acknowledges the effort of all the officers who have contributed material for compilation of the Volume 2. We are also grateful to the Editorial Board for going painstakingly through the write-ups and for their value addition.

N.P. Sinha
Chairman of the Committee

Acknowledgments

CONTRIBUTORS TO VOLUME 2

Smt. Anuja Sarangi	Chief Commissioner of Income-Tax, Mumbai
Shri Krishna Mohan Prasad	DGIT (I&CI), Delhi
Shri N.P. Sinha	Chief Commissioner of Income-Tax, Mumbai
Shri S.D. Jha	Chief Commissioner of Income-Tax, Delhi
Shri D.C. Patwari	Pr. Commissioner of Income-Tax, Mumbai
Shri Ravindra Kumar	Pr. Commissioner of Income-Tax, Mumbai
Shri R. Ravichandran	Pr. Director of Income-Tax (Inv.), Bengaluru
Shri Amal Garg	Commissioner of Income-Tax, Delhi
Shri Jasdeep Singh	Commissioner of Income-Tax, Chennai
Shri Kamlesh Varshney	Commissioner of Income-Tax, Kolkata
Shri L.K.S. Dehiya	Commissioner of Income-Tax, Mumbai
Shri M. Rathinsami	Commissioner of Income-Tax, Chennai
Shri Rahul Navin	Commissioner of Income-Tax, Delhi
Shri Rajeshwar Yadav	Commissioner of Income-Tax, Mumbai
Shri Ranjan Kumar	DIT (I&CI), Jaipur
Shri Sanjeev Sharma	Commissioner of Income-Tax, Delhi
Shri Sanjeev Singh	ADG (Systems), Delhi
Shri Sunil Jha	Commissioner of Income-Tax, Mumbai
Shri Krishna Prasad Goyal	Addl. Commissioner of Income-Tax, Indore
Shri Nilimesh Yadav	Addl. Commissioner of Income-Tax, Mumbai
Shri Raj Kumar Ghosh	Addl. Director of Income-Tax (Inv), Baroda
Shri Rajesh Mahajan	Addl. Director of Income-Tax (Inv), Pune
Shri Sanjeev Kashyap	Addl. Director of Enforcement, Mumbai
Shri Santosh Kumar	Addl. Director of Income-Tax (Inv), Delhi
Shri Dhruv Purari Singh	Dy. Director (Trg), NADT, Nagpur

Committee for Review and Updating of Manual
of
Techniques of Investigation for Assessment

Sr. No.	Name	Designation	Station	Position
1	**Shri Vinodanand Jha**	Chief CIT (Since Retired)	Mumbai	Chairman
2	**Shri N.P. Sinha**	Chief CIT	Mumbai	Chairman
3	**Shri K.K. Vyawahare**	DGIT (Inv.)	Mumbai	Member
4	**Shri A.D. Mehrotra**	Chief CIT	Ahmadabad	Member
5	**Shri Harish Kumar**	DGIT (Inv.)	New Delhi	Member
6	**Shri Nilimesh Baruah**	Chief CIT (Since Retired)	New Delhi	Member
7	**Shri Pravin Kumar**	Pr. DIT (Inv.)	Hyderabad	Member
8	**Shri Alok Johri**	Pr. DIT (Inv.)	Raipur	Member
9	**Shri Yogendra Choudhary**	PCIT	Mumbai	Member Secreatry
10	**Shri Sunil Kumar Singh**	CIT (Inv.)	CBDT	Member

Editorial Board for Volume 2

Shri N.P. Sinha
CCIT(C)-2, Mumbai

Shri K.K. Vyawahare
DGIT(Inv.), Mumbai

Shri C.S. Gulati
CIT(A)-1, Mumbai

Shri Rajeshwar Yadav
CIT(A)-47, Mumbai

Shri L.K.S. Dehiya
CIT(DRP)-1, Mumbai

Shri Ajit K. Srivastava
CIT(A)-17, Mumbai

Shri Sunil K. Jha
CIT(DRP)-2, Mumbai

Shri Vivek Anand Perampurna
Addl CIT, CR-7, Mumbai

Committee for Selection of Key Phrases/ Key Words for Index of Volume 2

Shri Amal Garg	CIT (A), Moradabad	Chairman
Shri Santosh Kumar	Addl. DIT, Unit-VI, Investigation, New Delhi	Member
Shri Vipul Agarwal	Addl. CIT (TP), New Delhi	Member

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CHAPTER

1

Basic Concepts of Transfer Pricing

1. INTRODUCTION

1.1 Globalisation, aided and abetted by advances in information technology, transportation and communication, have made easier for Multinational Corporations to have their business structures and organisations traddling across multiple jurisdictions. They have various supply chains, backward forward service linkages and such multifarious commercial and economic activities that happen within these organisations, i.e. intra group. In fact at world level such intra group transactions constitute about 30% of the all global trade. Had these transactions taken place in one jurisdiction, there is no case of focusing on them or examining them, unless and until they are either sham or taking place between entities that offer opportunities for tax arbitrage that is between entities where one of them is exempted from tax or enjoys lower tax rates (transactions presently covered under specified domestic transactions). Secondly, there are no multiple stake holders in the resultant tax pie arising from income from undertaking business activity involving those transactions. However, when the level of these transactions and their operations go beyond and across the borders, the number of stake holders become coterminous with the number of jurisdictions these transactions traverse. Simultaneously, issues pertaining to situs of accrual of income and which taxing jurisdiction has the right to tax those business entities and to what extent, also arise.

1.2 In addition, there are asymmetries regarding rates and incomes to be taxed among different jurisdictions that tempt and prompt MNCs to manipulate the pricing of these intra group controlled transactions when goods, services, capital and intangibles are transferred within the group so as to minimise the tax cost. Transfer pricing essentially emanates from these prices representing transacted value of an intra group transaction (also called transfer price) in controlled conditions. Since these transactions are not happening in a market situation the pricing is prone to arbitrariness and manipulation and can hence be misused to shift incomes to low tax incidence countries by inflating the expense in high tax jurisdictions or alternatively deflating incomes in high tax incidence country. World over incidents of MNCs misusing transfer pricing were being noticed, the major intention of which was avoidance of tax.

1.3 Prior to 2001 India was not equipped to deal with such tax avoidance techniques of MNCs and the erstwhile Section 92 was very lax, non-specific and vague. Therefore, it was realised that "increasing participation of Multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group." This situation necessitated the constitution of a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India. Therefore, in 2001 the old Section 92 was replaced and a new chapter X comprising Sections 92 to 92F with a heading "Special provisions relating to avoidance of tax" was introduced. Further to counter similar tax arbitrage opportunities amongst domestic taxpayers and between exempted and non exempted units or persons the SDT provisions were also incorporated in chapter X with effect from 1-4-2013.

2. THE MANDATE OF CHAPTER X AND CONCEPT OF ARM'S LENGTH PRICE

2.1 The mandate of the transfer pricing legislation as contained in Chapter X of the Act is to scrutinise both international transaction as well as specified domestic transaction (SDT) and see whether the intra group pricing of these transactions is at arm's length or not. Para 1 of Article 9 of the OECD Model Tax Convention describes the underlying principle of Arm's length price. It states:

"*Where conditions are made or imposed between the two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly*".

Basically, ALP i.e Arm's Length Price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions. The Act defines ALP in Section 92F(ii). The arm's length principle governs the determination of transfer prices among associated enterprises. The principle follows the approach of treating associated enterprises of an MNE group operating as independent entities rather than as a single unified business. The principle provides a broad parity of tax treatment for MNEs and independent parties. It puts associated enterprises and independent entities on equal footing for tax purposes. To establish arm's length price comparison is made between the prices charged in a controlled transaction to comparable transactions between independent parties.

2.2 The ALP is to be determined by using one of the methods mentioned in Section 92C read with rule 10 B and rule 10 AB considered most appropriate depending upon the facts and circumstances of a case. These methods are comparable controlled price method (CUP), resale price method (RPM), cost plus method (CPM), profit split method (PSM), transactional net margin method (TNMM) and such other method as prescribed by Board. However, in each method transfer pricing analysis involves a thorough study of the assessee and the intragroup transactions (both international transactions as well as Specified Domestic transactions) followed by their comparison with similar transactions in comparable entities in uncontrolled conditions so as to ensure that the financial results or prices are similar if not same. The analysis (known as FAR analysis) involves examination and study of functions performed by the assessee, assets utilised and risks undertaken so that its profile can be completely outlined in the context of the multinational group it is a constituent of and also with whom to compare the assessee with.

2.3 This essentially implies comparison of a controlled transaction with an uncontrolled transaction, in other words, comparison of transactions happening between associated or related enterprises with transactions between independent entities. Thus comparability is the cornerstone of transfer pricing. For the purpose of comparability the international transactions and SDT are to be examined as provided for in Rule 10B (2) which for ready reference is reproduced below:

"(2) *For the purposes of sub-rule (1), the comparability of an international transaction or a specified domestic transaction with an uncontrolled transaction shall be judged with reference to the following, namely*:

a. *The specific characteristics of the property transferred or services provided in either transaction*;

b. *The functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions*;

c. *The contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions*;

d. *Conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail*."

The above rule entails a complete fact finding of the taxpayer entity under reference from all possible angles including economic, business and commercial aspects along with comparability analysis. If the entire exercise reveals that the price at which the intragroup transaction has taken place is not consistent with the ALP so determined then the prices of the controlled transactions are accordingly adjusted either upwards or downwards depending upon the facts and circumstances of the case.

2.4 The TP provisions, that is, the situations that require determination of ALP, are attracted in any of the following situations:

1. Where there is any income arising from an international transaction. {Section 92(1)}
2. Where there is allowance for any expense or interest arising from an international transaction. {Explanation to Section 92(1)}
3. Where in an international transaction or specified domestic transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises. {Section 92(2)}
4. Any allowance for an expenditure or interest or allocation of any cost or expense or any income in relation to the specified domestic transaction. {Section 92(2A)}

However the TP provisions shall not apply in a case where the computation of income under Section 92(1) Section 92(2A) or the determination of the allowance for any expense or interest under Section 92(1) or Section under 92(2A) or the determination of any cost or expense allocated or apportioned, or, as the case may be, contributed under Section 92(2) or Section 92 (2A), has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction or specified domestic transaction was entered into.

3. Before we proceed further certain terms need to be understood as they are envisaged, intended and defined in the provisions of Chapter X of the Income-tax Act. These terms and concepts with which one needs to be conversant with are– Enterprise, associated enterprise, International transaction, Specified domestic transactions, the most appropriate method.

3.1 WHAT IS AN ENTERPRISE?

Before going to the term "associated enterprise" it is essential that we understand the term "enterprise" which is defined in Section 92F(iii) of the Act. It means a person (including a permanent establishment of such person) who is, or has been, or is proposed to be, engaged in:

- *Any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copyrights, trade-marks, license, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or*
- *The provision of services of any kind, or*
- *The carrying out any work in pursuance of a contract, or*
- *Investment, or*
- *Providing loan, or*
- *The business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places*

It can be seen that the term is defined to mean a person engaged in the past, present or in the future in any activity relating to tangibles, intangibles, facilities or services with widest possible modes, forms or pattern of operation. It also includes a permanent establishment (PE) of such person.

For the purpose of SDT the term enterprise is defined in Rule 10 A (aa) to include in addition to the original meaning assigned in Section 92 F (iii) a unit or an enterprise or an undertaking or a business of a person who undertakes SDT.

3.2. WHAT IS AN ASSOCIATED ENTERPRISE? (AE)—SECTION 92A(1) AND ALSO RULE 10A (A)

Transfer pricing provisions apply to international transactions between associated enterprises. Accordingly, "associated enterprise", in relation to another enterprise, means:

i. *An enterprise which participates directly or indirectly or through one or more intermediaries in*:
   - o *Management of the other enterprise, or*
   - o *Control of the other enterprise, or*
   - o *Capital of the other enterprise*

ii. *An enterprise in respect of which one or more persons participate directly or indirectly or through one or more intermediaries in management, control or capital, are the same persons who participate, directly or indirectly or through one or more intermediaries in management, control or capital of the other enterprise*.

3.3 DEEMED ASSOCIATED ENTERPRISE RELATIONSHIP—SECTION 92A(2)

Section 92A(1) gives a broad indicator as to when two or more enterprises can be deemed to be Associated Enterprises. However, the Section does not clearly explain the situations when control, management or capital is said to

be established. Section 92A(2) provides a list of 13 situations during which associate enterprise relationship is said to have been established:

a. "One enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise; *or*

b. *Any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or*

c. *A loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise;* or

d. *One enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or*

e. *More than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or*

f. *More than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or*

g. *The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights;* or

h. *Ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or*

i. *The goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or*

j. *Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or*

k. *Where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or*

l. *Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or*

m. *There exists between the two enterprises, any relationship of mutual interest, as may be prescribed*."

Out of the above 13 situations, capital based relationships are specified at Clauses (a), (b), (c) and (l) above; control based relationships are specified at Clauses (d), (g), (h), (i), (j) and (k); management based relationships are specified at Clauses (e) and (f). Clause (m) is a residuary Clause. No relationship has yet been prescribed.

3.3.1 For the purposes of SDT the term AE has been suitably elaborated by having it separately defined and made applicable to Rules 10AB to 10 E. Rule 10A defines "associated enterprise" as under:

"associated enterprise" shall,—

i. *have the same meaning as assigned to it in Section 92A; and*

ii. *in relation to a specified domestic transaction entered into by an assessee, include —*

a. *The persons referred to in Clause (b) of sub-section (2) of Section 40A in respect of a transaction referred to in Clause (a) of sub-section (2) of the said Section;*

b. *Other units or undertakings or businesses of such assessee in respect of a transaction referred to in Section 80A or, as the case may be, sub-section (8) of Section 80-IA;*

c. *Any other person referred to in sub-section (10) of Section 80-IA in respect of a transaction referred to therein;*

d. *Other units, undertakings, enterprises or business of such assessee, or other person referred to in sub-section (10) of Section 80-IA, as the case may be, in respect of a transaction referred to in Section 10AA or the transactions referred to in Chapter VI-A to which the provisions of sub-section (8) or, as the case may be, the provisions of sub-section (10) of Section 80-IA are applicable"*

4. WHAT IS AN INTERNATIONAL TRANSACTION?

4.1 Before considering the term "International Transaction" one needs to know the term "transaction" which has been defined in Section 92 F (v) as under:

'transaction' includes an arrangement, understanding or action in concert,—

a. *Whether or not such arrangement, understanding or action is formal or in writing; or*

b. *Whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding*

It may be noted that it states that the arrangements and understanding need not be in writing or may not be enforceable by legal proceedings or may be informal also.

4.2 Whereas the term "international transaction", a cross border derivative of the term "transaction", refers to a transaction between two or more associated enterprises, either or both of whom are non residents, in the nature of:

- Purchase, sale or lease of tangible or intangible property, or
- Provision of services, or
- Lending or borrowing money, or
- Any other transaction having a bearing on the profits, income, losses or assets of such enterprises.
- It also includes a mutual agreement or arrangement between two or more associated enterprises for:
- Allocation or apportionment of, or
- Any contribution to,

any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to one or more of such enterprises.

4.3 It needs to be mentioned here that the scope of term "International Transaction" was further clarified and explained by retrospective amendment made by the Finance Act, 2012 w.e.f. from 1-4-2002 as under:

" *the expression "international transaction" shall include—*

a. *The purchase, sale, transfer, lease or use of tangible property including building, transportation vehicle, machinery, equipment, tools, plant, furniture, commodity or any other article, product or thing*;

b. *The purchase, sale, transfer, lease or use of intangible property, including the transfer of ownership or the provision of use of rights regarding land use, copyrights, patents, trademarks, licenses, franchises, customer list, marketing channel, brand, commercial secret, know-how, industrial property right, exterior design or practical and new design or any other business or commercial rights of similar nature*;

c. *Capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business*;

d. *Provision of services, including provision of market research, market development, marketing management, administration, technical service, repairs, design, consultation, agency, scientific research, legal or accounting service*;

e. *A transaction of business restructuring or reorganisation, entered into by an enterprise with an associated enterprise, irrespective of the fact that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date*;"

4.4 The aforementioned retrospective amendment also expanded and explained the term "intangible property" used in the definition of term "International Transaction" to specifically include all intellectual property related items like marketing intangibles.

4.5 In addition, there is also a deeming provision to cover those transactions that are predefined prior to any agreement because an AE is already committed to a transaction and it transfers its commitment to other associated enterprise. Section 92B(2) defines "Deemed International Transactions" between associated enterprises as under:

"*A transaction entered into by an enterprise with a person other than an associated enterprise shall be deemed to be an international transaction entered into between two associated enterprises, if*:

- *There exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or*
- *The terms of the relevant transaction are determined in substance between such other person and the associated enterprise*,

where the enterprise or the associated enterprise or both of them are non-residents irrespective of whether such other person is a non-resident or not."

5. WHAT IS A SPECIFIED DOMESTIC TRANSACTION?

The Finance Bill 2012 amended TP provisions and made the TP provisions applicable to specified domestic transactions with effect from 1-4-2013. The amendment was in pursuance of the directions of the Hon'ble Supreme Court of India in the case of *CIT vs. Glaxo Smith Kline Asia (P) Ltd*. The meaning of "specified domestic transactions" has been provided in Section 92 BA as under:

"For the purpose of this Section and Sections 92, 92C, 92D and 92E, "specified domestic transaction" in case of an assessee means any of the following transactions, not being an international transaction, namely:

i. Any expenditure in respect of which payment has been made or is to be made to a person referred to in Clause (b) of sub-section (2) of Section 40A;

ii. Any transaction referred to in Section 80A;

iii. Any transfer of goods or services referred to in sub-section (8) of Section 80IA;

iv. Any business transacted between the assessee and other person as referred to in sub Section 10 of Section 80IA;

v. Any transaction, referred to in any other Section under chapter VIA or Section 10AA, to which provisions of sub Section 8 or sub-section 10 of Section 80IA are applicable; or

vi. Any other transaction as may be prescribed, and where the aggregate of such transactions entered into by the assessee in the previous year exceeds a sum of twenty crores* rupees."

The above Section shows that there are basically two categories of SDT- One between resident related parties pertaining to expenditure and the other between domestic AEs with one of them availing tax holiday benefits as provided for in Chapter VI A and under Section 10AA of the IT Act.

6. VARIOUS METHODS FOR DETERMINING THE ARM'S LENGTH PRICE-CUP, RPM, CPM, TNMM, PROFIT SPLIT AND ANY OTHER METHOD

6.1 The arm's length price in relation to an international transaction or a SDT shall be determined by any one of the above mentioned methods, being the most appropriate method, in the following manner:

Method	Steps Involved
Comparable Uncontrolled Price Method (CUP)	(i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified. (ii) such price is adjusted to account for differences, if any, between the international transaction or the specified domestic transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market (iii) the adjusted price arrived at (ii) above is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction.
Resale Price Method (RPM)	(i) The price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified (ii) such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions (iii) the price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services: (iv) the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction or the specified domestic transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market; (v) the adjusted price arrived at (iv) above is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise

* w e f 1-4-2016

Cost Plus Method (CPM)	(i) the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined (ii) the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined (iii) the normal gross profit mark-up referred to in sub-Clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction or the specified domestic transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market (iv) the costs referred to in (i) above are increased by the adjusted profit mark-up arrived at under (iii) above (v) the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise
Profit Split Method (PSM)	This method may be applicable mainly in international transactions or the specified domestic transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction. This method involves the following steps: (i) the combined net profit of the associated enterprises arising from the international transaction or the specified domestic transaction in which they are engaged, is determined (ii) the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances (iii) the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated at (ii) above (iv) the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction or the specified domestic transaction. However the combined net profit referred to in (i) above may, initially, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction or the specified domestic transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified at (ii) and (iii) above, and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction.
Transactional Net Margin Method (TNMM)	(i) the net profit margin realised by the enterprise from an international transaction or a specified domestic transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base. (ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base. (iii) the net profit margin referred to in (ii) above arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction or the specified domestic transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market. (iv) the net profit margin realised by the enterprise and referred to in (i) above is established to be the same as the net profit margin referred to in (iii) above. (v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction or the specified domestic transaction.

Other Method	Any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction with or between non-associated enterprises under similar circumstances considering all the relevant facts.

6.2 In the Indian TP provisions as such there is no hierarchy of methods but only one method has to be used for determining the ALP of an international transaction or SDT. Different transactions can be benchmarked using different method. The most appropriate method shall be decided based on the following illustrative factors:

a. Nature and class of international transaction

b. Nature of the associated enterprise

c. Availability of reliable data

d. Extent to which accurate adjustments can be made to account for differences

e. Degree of comparability with uncontrolled transactions

f. Nature and extent of reliable assumptions.

6.3 Section 92C states that ALP of an International Transaction or a SDT shall be determined having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe. The same has been prescribed in Rule 10B(2). These are primarily comparability factors of comparing the given controlled transaction under consideration with uncontrolled transaction. Rule 10B(2) states as follows:

"For the purposes of sub-rule (1), the comparability of an international transaction or a specified domestic transaction with an uncontrolled transaction shall be judged with reference to the following, namely:

a. The specific characteristics of the property transferred or services provided in either transaction;

b. The functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

c. The contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

d. Conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail."

6.4 The above comparability analysis requires first to understand the transaction that needs comparison. Only then the parameters of comparing that transaction with uncontrolled transactions can be decided. The exercise undertaken to comprehend the transactions that involves extensive fact finding and marshalling of facts involving aforementioned reference points in Rule 10B(2) is known as FAR analysis in TP parlance. FAR analysis means complete understanding of the functions (F) performed by the assessee in the context of its associated enterprises as well as an independent entity, complete appraisal of the assets (A) utilised for undertaking the functions and then the risk (R) undertaken in the carrying out of the said International Transaction (as higher the risk, higher the reward). On the basis of FAR the similarly placed comparables are selected performing similar functions, using similar assets

and taking similar risks. If exact comparable are not found some adjustments can also be made to make them comparable as provided in Rule 10B(3) as follows

"(3) An uncontrolled transaction shall be comparable to an international transaction or a specified domestic transaction if—

i. None of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or

ii. Reasonably accurate adjustments can be made to eliminate the material effects of such differences."

7. BRIEF DISCUSSION ON FAR ANALYSIS

7.1 For proper comparability, it is essential to understand and comprehend the controlled transaction in its totality as it is placed in time and space. This necessitates a thorough study of the taxpayer entity and its constituent group. After placing it in the segment of industrial classification the examination of other features is also of equal importance. Any analysis should start with a thorough study of the financials of the taxpayer. To start with it needs to be noted whether it is earning profits over the years or is booking losses over the years? If there are losses what are the reasons stated for the same? The profiling of the taxpayer as per FAR in respect of the International Transaction should then follow.

7.2 With respect to the 'functions performed' it should be seen whether the entity is a distributor or a manufacturer; whether it is a full-fledged manufacturer or a contract manufacturer or a mere assembler. In its distribution function, whether it is a limited risk distributor or a full-fledged distributor. To what extent it is taking up the task of sales, marketing and promotion. Whether it is contributing anything through its R&D development division to the development of any trade intangibles or not? The functions can be deduced from the various agreements like the service agreement, manufacturing agreement, royalty agreements, etc. The contractual obligations have to be compared with the actual conduct. For example, the taxpayer may otherwise be claiming to be a full-fledged manufacturer but it may be observed that it is actually a contract manufacturer with all its production based on exact orders received and bearing no inventory or any other risk like marketing or even sale.

7.3 Similarly, the 'assets' that are put to use or employed are to be studied, the kind of machinery it has, the technology that is engaged and the intangibles that are in place or are being developed needs to be seen in order to appreciate the kind of entity being examined. The kind of dealer network it has developed Chat data, the kind of professional or employee expertise it has developed or if it is having a R & D department whether it is contributing to the development of any commercial industrial intangibles, etc, need to examined.

7.4 In addition to the above, the 'Risks' that the taxpayer is assuming are also to be seen. Risks are defined as the effect of uncertainty on the objectives of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. No profit seeking business takes on risk associated with commercial opportunities without expecting a positive return. Profit allocation is to be aligned with the assumption of risks in the business and the risk should be real and observable in conduct not a mere contractual construct. It is to be seen whether taxpayer is bearing the capital risk? Whether it is bearing the inventory risk, whether it is taking the marketing risk? The higher the risk, the higher will be the entitlement to return.

It needs to be ascertained that the risk claimed to be taken by the taxpayer should be the real risk not something merely contractually assigned and which does not bear any resemblance to the actual conduct of the taxpayer. For example, the taxpayer may claim as per contract that they take the risk of publicity but all decisions are actually decided by their parent. Thus the same would be contrary to what is proclaimed in the contract.

7.5 The FAR of the company in relation to the International Transaction is very important because in many instances one may come across a situation where though the company may be projecting itself as a full-fledged manufacturer but it may turn out to be an assembler of CKDs. The business model is very important for the purpose of comparability-one cannot compare a full-fledged manufacturer with an assembler. Similarly, a contract manufacturer cannot be compared with a full-fledged manufacturer. Contract manufacturing has a different set of pricing than the full-fledged manufacturer and different set of comparable companies too. For example, most of the foreign companies involved in manufacturing of automobiles in India are the subsidiaries of parent companies situated abroad. The Indian company or the Indian subsidiary is involved in the manufacturing of the vehicle and the parent company is either supplying the technology or the brand for the same. The other constituents of the group are also supplying various kinds of materials to the Indian subsidiary. There are also instances where the Indian subsidiary is either supplying the raw material to the constituents of the group abroad or supplying manufactured vehicles and spare parts to foreign countries for sale abroad. Therefore, it can be seen from the profit and loss account of the Indian subsidiary involved in manufacturing of automobiles that there are international transactions involved with associated enterprises on expenditure side as well as revenue side. Depending upon the facts and circumstances of the case there can be an incentive for the Indian subsidiary to over invoice its purchases and also under invoice its sales to the foreign subsidiaries, especially when they are situated in a low tax country. Thus the location of the other constituents of the MNC group of the Tax payer is important and can suggest an important line of investigation.

7.6 On the basis of FAR analysis qualitative and quantitative parameters of comparability can be decided. These parameters could be like type of Industry, ownership, turnover, capital intensive, employee based, financial parameters, assets base, etc. These parameters take the form of filters when applied to databases used to search and select comparable companies.

7.7 Data Bases: 'Prowess' and 'Capitaline' are two of the most popular domestic databases for the purpose of comparison. Prowess is a database of the financial performance of over 30,000 Indian companies. Annual reports of individual companies is the predominant source of this database. The database covers both listed and unlisted companies. In the case of listed companies, the database includes data sourced from the stock exchanges apart from annual reports. Capitaline is also a similar database of over 30,000 listed and unlisted companies which are categorized into more than 300 industry classifications.

7.8 Both these databases provide an electronic platform for comprehensive vertical and horizontal analysis of industry including generating customized reports based on profit margins, ratio analysis, etc. Apart from these two popular databases, few other databases are also available for the purpose namely:

i. IBFD
ii. Edgarstat
iii. Bloomberg BNA

Along with databases the TPO is at liberty to gather information by using the provisions of 131, 133(6) and exchange of information and

the information intended to be used against the assessee has to be confronted and his reply to be effectively countered.

7.9 After comparing the intra group transaction under reference with the uncontrolled transaction as per the selected method of determination of ALP if it is found that the transfer price of the transaction under reference is at variance with the ALP determined then adjustment to the price of the transaction is made-the transaction may be adjusted upwards or downwards depending upon the facts and circumstances of the case.

8. THE RANGE CONCEPT AND MULTIPLE YEAR DATA

8.1 Before 1-4-2015 if more than one price was determined by the most appropriate method then the ALP was to be taken to be the arithmetical mean of such prices. But w.e.f. 1-4-2015, Range concept has been introduced by Finance Act, 2014. Also, earlier the emphasis was on contemporaneous data and single year financial data was used for comparison purposes but from 1-4-2015 taxpayer can base its comparability on multiple year data.

8.2 Use of multiple year data would be applicable only in cases where Resale Price Method (RPM) or Cost Plus Method (CPM) or Transactional Net Margin Method (TNMM) has been selected as the Most Appropriate Method (MAM). For each comparable, the data shall relate to the current year. In case such data is not available at the time of furnishing the return of income, data pertaining to up to two preceding financial years may be used. Current year data, if available during assessment, shall be used. If a comparable is selected on the basis of preceding year data but is not found to be comparable for the current year for qualitative or quantitative reasons, then such comparable would need to be rejected from the data set. When using multiple year data, data for each comparable shall be the weighted average of the selected years.

8.3 The 'range concept' shall be applicable when: (a) the MAM is either Comparable Uncontrolled Price (CUP) Method, RPM, CPM, or TNMM; and (b) there are at least 6 comparables. Where these conditions are not fulfilled, 'arithmetic mean' shall continue to apply, as before, along with the tolerance range benefit.

8.4 Once the values in a data set are arranged in ascending order, the arm's length range would be data points lying between the 35th and 65th percentile of the data set. If the transaction price falls within the range, then the same shall be deemed to be the ALP. If the transaction price falls outside the range, the ALP shall be taken to be the median of the data set.

9. WHAT ARE THE COMPLIANCE REQUIREMENTS OF TAXPAYER ENGAGED IN INTERNATIONAL TRANSACTIONS OR SDT?

9.1 As per Section 92E every person who has entered into an international transaction or SDT during a previous year shall obtain a report from an accountant and furnish such report on or before the specified date in the prescribed form duly signed and verified in the prescribed manner by such accountant and setting forth such particulars as may be prescribed. As per Rule 10E, the report from an accountant required to be furnished under Section 92E by every person who has entered into an international transaction or SDT during a previous year, shall be in Form No. 3CEB and shall be verified in the manner indicated therein.

9.2 From 1-4-2017 a new Section 286 is inserted by Finance Act 2016 wherein there is an additional requirement of filing country by country report and master file for entities engaged in international transactions in India. This Section is introduced as per the OECD recommendations made as a consequence of its report and action plan to counter base erosion and profit shifting strategies of Multinational Enterprises. The OECD report on Action Point

13 of BEPS Action plan provides for revised standards for transfer pricing documentation and a template for country-by-country reporting of income, earnings, taxes paid and certain measure of economic activity. India has been one of the active members of BEPS initiative and part of international consensus. It is recommended in the BEPS report that the countries should adopt a standardised approach to transfer pricing documentation. A three-tiered structure has been mandated consisting of:

i. A master file containing standardised information relevant for all multinational enterprises (MNE) group members;

ii. A local file referring specifically to material transactions of the local taxpayer; and

iii. A country-by-country (CbC) report containing certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.

9.3. THE DOCUMENTATION REQUIREMENT OF THE ASSESSEE

Section 92D states that every person who has entered into an international transaction or SDT need to maintain prescribed details relating to the transaction. At the time of tax audit, the Assessing Officer may call for the documents for submission within a period of 30 days. This period could be extended by another 30 days. Thus the assessee needs to maintain relevant data to support the pricing adopted for the transaction.

An assessee needs to maintain certain basic data relating to the international transaction. Rule 10D prescribes the information and documents that are to be maintained as stipulated under Section 92D.

a. Overview of the Company and the group

b. Details of the business

c. Associated Enterprise relationship

d. Industry analysis including the industry classification and the outlook for the industry

e. Details of the all the international transactions/ specified domestic transaction, separately

f. Terms of the transaction

g. FAR analysis

h. Financial information

i. Process of selection of Tested Party

j. Evaluation of Methods and selection of the Most Appropriate Method

k. Economic Analysis

l. Computation of Arm's Length Price.

To the above list of documents, further list of documents could be added which is required to be filed by entities involved in international transactions as per Section 286 of the Act.

10. REFERENCE AND THE TP ASSESSMENT: THE PROCEDURAL ASPECTS

10.1 Chapter X of Income-tax Act deals with the procedural aspects. As per Section 92C (3), the assessing officer can determine the Arm's Length Price of the transactions entered into with the Associated Enterprises. However, if the Assessing officer considers it necessary, the case may be referred to TPO *u/s* 92CA(1) of the Act. The selection of cases for reference has been further streamlined by issue of Instruction 3 of 2016 providing guidelines for implementation of Transfer Pricing provisions. These instructions should be carefully studied before making a reference to the TPO.

10.2 On receipt of reference, the following are the procedures to be followed by the TPO;

- Serve a notice *u/s* 92CA (2)
- Call for documents *u/s* 92D(3) within 30 days (extendable by a further period not exceeding 30 days, on application by the assessee) failing which penalty is leviable *u/s* 271G
- Pass an order in writing *u/s* 92CA(3)
- Order of TPO is binding on the AO– Section 92CA(4)
- Rectification of mistake *u/s* 92CA (5)/ (6)
- TPO has powers to call for information *u/s* 131 (1) and 133 and also to conduct a survey *u/s* 133A
- Time limitation for passing order *u/s* 92CA(3) is 60 days prior to the Time barring date for the assessing officer to pass assessment order.

11. THE APPELLATE PROCEDURE - DRP AND CIT (APPEAL) - DRAFT ASSESSMENT ORDER *VS.* ASSESSMENT ORDER

Once an adjustment to the Arm's Length Price is proposed in the Order *u/s* 92CA(3), the assessing officer has to necessarily pass a draft assessment order as per the provisions of Section 144C(1) of the Act. On receipt of the draft assessment order, the assessee has an option to object the order by filing with DRP within one month or accept the same before the assessing officer. Once the assessee accepts the order or has not filed any objection before DRP, the assessing officer has to pass the final order against which the assessee can appeal before the CIT (A). When assessee files objection before DRP, the DRP shall issue directions *u/s* 144(5) within nine months, on receipt of which the assessing officer shall pass the final order in accordance with the directions of DRP within one month. Against this final order, the assessee can file appeal before ITAT.

12. PENALTIES INVOLVED

The penalties involved for the sake of brevity can be tabulated as follows:

Section	Default	Penalty
271(1)(c)*	Penalty for concealment of income	Between 100% to 300% of additional tax liability
271AA(1)	Non-maintenance of information and documents as required *u/s* 92D(1) or (2), non-reporting of transactions or maintaining/ furnishing incorrect information/ document	2% of the value of each transaction
271AA(2)	Failure to furnish information and documents as required *u/s* 92D(4)	5 lakh
271BA	Failure to furnish report of a chartered accountant as required *u/s* 92E	1 lakh
271 G	Failure to furnish information or documents required *u/s* 92D(3) before AO/ TPO/ CIT(A)	2% of the value of each transaction
271GB(1)	Failure to furnish report required *u/s* 286(2) by the reporting entity	(a) Rs. 5,000 for every day for which failure continues, if the period of failure does not exceed one month; or (b) Rs. 15,000 for every day for which the failure continues beyond the period of one month.

271GB(2)	Failure to produce the information and documents within the period allowed *u/s* 286(6)	Rs. 5,000 for every day during which failure continues beginning from the day following the day on which the period expires
271GB(3)	Failure *u/s* 271GB(1) or (2) continues after an order has been served directing to pay the penalty	Rs. 15,000 for every day for which the failure continues beginning from the date of service of such order
271GB(4)	Providing inaccurate information in the report *u/s* 286(2)	Rs. 5,00,000, subject to satisfaction of certain conditions.

*new Section 270A from AY 2017–18 onwards. It has two different rates, i.e. 50% of tax payable on under-reported income and 200% of tax payable on mis-reported income.

13. SOME TYPICAL ISSUES IN TRANSFER PRICING IN INDIA

The adjustments are made mostly on the following issues:

a. Profit Margin adjustments are made wherever the margin of the assessee are much below the margin of the comparables.

b. Where the business segments for determining the ALP are not properly drawn by the assessee the same are reworked depending upon the FAR analysis carried out by the assessee and then the adjustments are carried out.

c. Some adjustments are done by disallowing certain revenue or expenditure items which are not operating in nature. The reworking of the margins after disallowing these non operating revenue and expenditures items leads to adjustments.

d. Some of the international transactions are discovered during the TP proceedings and therefore benchmarked separately like some deemed international transactions and also the AMP adjustments.

e. There are certain adjustments based upon the rejection of the most appropriate method used by the assessee and replacing the same by another method.

f. In many cases 'the other method' of determination of ALP was used where there are issues involving valuation of intangibles etc.,

g. Determination of ALP of interest, receivables, corporate guarantees, royalties and other intra group services is being done based on transaction by transaction approach instead of benchmarking at entity level.

14. MEASURE TO REDUCE LITIGATION AND NON ADVERSARIAL MEASURES–SAFE HARBOUR RULE, ADVANCE PRICING AGREEMENT

14.1 Section 92CB of the Act defines the term "Safe Harbour" as "circumstances under which the Income-tax authorities shall accept the transfer price declared by the assessee." The Rule provides minimum operating profit margin in relation to operating expenses a taxpayer is expected to earn for certain categories of international transactions, that will be acceptable to the Income-tax authorities as arm's length price (ALP). The rule also provides acceptable norms for certain categories of financial transactions such as intra-group loans made or guarantees provided to non-resident affiliates of an Indian tax payers. The safe harbor rules, optional for a taxpayer, contains the conditions and circumstances under which norms/ margins would be accepted by the tax authorities and the related compliance obligations.

14.2 The safe harbour rules are not arm's length prices, but in the nature of presumptive taxation, which generally enthuse taxpayers to

opt for the same, as a compromise for not having to be involved in protracted litigation. Safe harbor typically include a premium payable by taxpayers for avoiding disputes and protracted litigations. Safe harbours may broadly take two forms- (a) outright exclusion by setting thresholds; or (b) simplification of provisions by designating range, within which prices/ profits should fall.

14.3 APA refers to an agreement between the taxpayer and the tax authorities for determining the ALP or manner of determination of ALP, for transactions with associated enterprises. An APA can be unilateral, bilateral or multilateral. Although the TP regulations have been expanded to cover even Specified Domestic Transactions, the option of APA is currently not available for such transactions. Once an APA has been entered into, the ALP with respect to the international transactions under consideration would be determined in accordance with the terms agreed in the APA for the agreed period (subject to a maximum of 5 years). Subject to fulfilment of specified conditions and upon choosing to do so, the taxpayer can seek application of the terms of already concurred position under an executed APA, to prior years (maximum of 4 years immediately preceding the first year for which the APA is agreed). In other words, under the Indian TP regime, an APA has the potential to provide TP certainty up to 9 years.

15. BEPS ACTION PLAN AND RECENT CHANGES: ACTION PLAN 8–10 AND ACTION PLAN 13

15.1 The OECD, along with G20 countries, launched the BEPS Project in September 2013 to curb aggressive tax planning by MNEs through intra-group transactions. Being a part of the G20, India has been an active participant in the BEPS Project and is committed to align the Indian TP Regulations with BEPS project recommendations. BEPS is a consequence of MNCs discreetly avoiding the tax-net by leveraging upon the asymmetries in taxation. Asymmetry is having differences in taxation among various tax jurisdictions. OECD has confirmed that there is significant leakage of revenue on account of BEPS. One such estimate puts that figure at around 100 to 250 Billion Euro, constituting about 10% of the global taxes. Once the perception was found to be correct, OECD came out with 15 action points that, as envisaged, would be able to counter the menace of BEPS. OECD has embarked upon to deal with BEPS in a comprehensive and wholistic manner at global level so that there are minimal unilateral action by countries that could otherwise lead to double taxation.

15.2 The main focus on TP issues is given in action plan 8, 9 & 10. The final report on action points 8, 9 & 10 has reaffirmed its faith in the arm's length principle but is also willing to deliberate on the variants of the same so as to ensure that the profits arising from economic activities get rightfully taxed in the jurisdictions where values are created. The work on transfer pricing under BEPS action plan has focused on three key areas as follows:

Action 8 looked at TP issues relating to transactions involving intangibles since misallocation of profit generated by valuable intangibles have contributed to BEPS (expenditure)

Action 9 - Work under Action 9 considers the contractual allocation of risks and resulting allocation of profit to those risks which may not correspond with the activities actually carried out. For example, contractually, the risks of R&D may be assigned to an entity in a tax haven but in reality, this entity will only be financing the entire R&D carried out in some other jurisdiction. This contractual misallocation of risks is at variance with the conduct of the parties. The actual conduct of the entities show that the risks rest with the entity which is performing the function

and not with the entity which is only financing the same without any risks involved.

Action 10 focuses on other high risk areas including the scope for profit allocation resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterization), the scope for targeting the use of TP method in a way which results in diverting profits from the most economically important activities of the MNE group and neutralizing the use of certain types of payments between members of MNA groups (such as management fees, head office expenses) to erode the tax base in the absence of aligning with value creation (intra group services).

15.3 The objective of Action Plan 13 of the BEPS project is to develop rules regarding TP documentation to enhance transparency for tax administration. The enhanced transparency is to enable them to conduct an informed TP risk assessment and collect useful information that could be used while conducting audit of TP practice of the entities. In order to achieve the above stated objective, BEPS Action plan has recommended a three-tiered approach to TP documentation, *viz*, Master File, Local File and Country by Country Report. Section 286 is a consequence of Indian acceptance of these recommendations of the BEPS action.

16. CONCLUSION

Transfer pricing is a vast field and involves looking across many borders, many agreements, many motives, many businesses, many aspects, multiple rules and regulations, multiple financials of the multinational group and multiple financials of the comparables companies and as such is an onerous task. Therefore, a conceptual clarity is a prerequisite before one ventures into it. It is difficult to summarise the basic concepts within few pages when each concept is capable of expanding into a chapter unto itself. However, we have attempted to present the concepts arranged in an outline with one following the other so as to enable handholding the new TPO on his/ her journey of a transfer pricing audit.

CHAPTER

2

Comparability Analysis for Application of Arm's Length Principle

1. INTRODUCTION

This chapter deals with aspects surrounding the comparability analysis and will bring out a conclusion that why is it so important to carry out a robust comparability analysis? The analysis is mainly based on the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, 2017 version (hereinafter OECD TP guidelines) and United Nations Practical Manual on Transfer Pricing for Developing Countries (2017) (hereinafter UN TP guidelines)[1] and personal experiences gained. The TPOs/ AOs are advised to refer to the relevant provisions of the Act and Rules for understanding the definitions of various terms used in the law, transfer pricing methods, documentation requirements, and transfer pricing assessment and related issues. They should also find time to study the OCED and UN TP guidelines. The UN TP guidelines have explained the issues by citing examples and can be given preference in reading.

1.1 Application of the arm's length principle for transfer pricing requires comparison of price charged or profits earned in controlled transaction between the associated enterprises with the price charged or profits earned by independent enterprises in a comparable uncontrolled transaction under similar circumstances. The controlled transaction would meet the test of arm's length if the price charged or profit earned in the transaction is what the independent enterprises would have earned in comparable transaction under similar circumstance. To meet the requirement of Section 92 of the Act, the taxpayers carry out functions performed, assets used and risks assumed (FAR) analysis of the controlled transactions in their transfer pricing study report and based on that economic analysis is carried out to justify that pricing of controlled transactions satisfy the arm's length conditions.

[1]Pdf copy of the Manual is available on http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf. This is the second edition. The first edition was published in 2013.

1.2 Since the introduction, the transfer pricing provisions in the Act have become the most important tax issue affecting the multinational enterprises operating in India. The comparability analysis is the cornerstone for the application of transfer pricing law and therefore it must be reliable and should not create unnecessary burden for taxpayers and tax administration (See paragraph 1.7 of the OECD Guidelines[2]). About 12 transfer pricing audit cycles have been completed since the introduction of transfer pricing law in the Income-tax Act, 1961 (the Act) and experience shows that the taxpayers in most cases use transactional net margin method at entity level to demonstrate that their international transactions meet the arm's length requirement. Their economic analysis is very simple and they identify entities as comparable whose average of financial indicator in almost all cases is less than that of the Applicant. Our audits have mostly focused on selection of comparables and disputes at all appellate level have in most cases centered around on the identification of comparables. In the process of selection of comparables either side to the dispute can give innumerable reasons to support their position. The identification of comparable uncontrolled transaction or comparable entity hinges on sound understanding of the controlled transaction or the economically relevant characteristics of the taxpayer subject to the audit. It is necessary to properly analyze and understand with respect to what parameters, the comparability is required to be established.

1.3 Legal Basis

Article 9 (1) of the OECD Model Tax Convention on Income and Capital provides the authoritative statement of the Arm's Length Principle. It reads as follows:

> *"[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."*

Similar statement is available in Article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries. Almost all the comprehensive double taxation avoidance agreements (DTAAs) signed by India with other countries contain similar provision. Tax treaties provided authority to adjust profits not earned due to non-arm's length behavior of the taxpayers but India did not have proper transfer pricing law till it was enacted by Finance Act, 2001. These provisions, made effective from April 1, 2001, were mainly based on arm's length principle. Section 92F of the Act defined the term 'arm's length price' *to mean a price that is applied or is proposed to be applied to transactions between persons other than associated enterprises in uncontrolled conditions.* Finance Act, 2001 introduced Sections 92 to 92F in the Act that provided the legal basis for application of arm's length principle for transfer pricing adjustment.

[2]The Organisation for Economic Cooperation and Development (OECD) had issued Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration in 1995. These guidelines were revised and supplemented to incorporate various changes in different years. The Guidelines were substantially revised in 2015 to incorporate changes due to Report on BEPS Actions 8–10 *Aligning Transfer Pricing Outcomes with Value Creation* and the Report on BEPS Action 13, *Transfer Pricing Documentation and Country-by-Country Reporting.* The reference to the OECD guidelines in this Paper is of the latest version of July 2017 and a pdf version of the same can be accessed at https://www.wtsserbia.com/wp-content/uploads/2018/01/OECD-Transfer-Pricing-Guidelines-2017.pdf

1.4 Arm's Length Principle

The arm's length principle is based on the assumption that commercial and financial conditions between independent parties reflect market conditions and an independent party will only enter into the transaction if they see no better alternative to meet their commercial objectives. The arm's length principle follows the approach of treating the members of the MNE group operating as separate entities. The principle authorizes to assess and if required to adjust the profits of an enterprise derived from transactions with associated enterprise by reference to the conditions that would have been made between the independent enterprises in comparable transactions under comparable circumstances. The arm's length methodology looks for simulation of conditions of commercial and financial relations between related enterprises to that made between independent enterprises. Transaction between members of the MNE Group or related parties or associated enterprises is termed as "*controlled transaction*" and a transaction between independent enterprises or unrelated parties is called as "*uncontrolled transaction*". Comparable transaction between independent enterprises in comparable circumstances is termed as "*comparable uncontrolled transaction*".

1.5 Meaning of the Comparability Analysis

'*Comparability analysis*' can be defined as the identification of transaction between the associated enterprises and subsequent comparison of the conditions in the controlled transaction with those of conditions in comparable uncontrolled transactions. Comparability analysis is one of the most important element in the implementation of the arm's length principle and it deals with the comparison of the conditions in the controlled transactions with the comparable transactions between independent parties (comparable uncontrolled transactions or comparables). To put simply, comparability analysis involves examination of two issues: the controlled transaction under review and the uncontrolled transactions that can be regarded as potentially comparable. For the application of arm's length principle as authorized by the domestic law and tax treaties, it is necessary to carryout comparability analysis so as to determine whether a profit or price adjustment is warranted and, if yes, then how much profits would have accrued at arm's length, for determining the amount of profit adjustment or what would have been price at arm's length. Comparability analysis is the foundation for applying the arm's length principle because it introduces the need for:

a. *Comparison between conditions (including but not limited to prices) made or imposed between associated enterprises and those which would be made between independent enterprises, in order to determine whether a re-writing of accounts for the purposes of calculating tax liabilities of associated enterprises is authorized;*

b. *Determination of the profits which would have accrued at arm's length, in order to determine the quantum of any re-writing of accounts.*

1.6 Standards of Comparability

Rule 10 B (3) of Income-tax Rules, 1962 stipulates the standard of comparability and these are:

An uncontrolled transaction shall be comparable to an international transaction [or a specified domestic transaction] if—

(i)	*None of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or*
(ii)	*Reasonably accurate adjustments can be made to eliminate the material effects of such differences.*

Controlled and uncontrolled transactions are regarded as comparable if the economically relevant characteristics of the transactions being compared and the circumstances surrounding them are sufficiently similar and these provide a reliable measure of an arm's length result. The Rules Recognise that in real world two transactions are seldom completely comparable and to be comparable does not mean that those are identical. There may be differences but such differences either should not materially affect the arm's length price or profit considered as a measure of arm's length, or where any of such material differences exist, than reasonably accurate adjustments can be made to eliminate their effect. In determining the reasonable degree of comparability, adjustments may need to be made to account for certain material differences between controlled and uncontrolled transactions. The comparability adjustments should only be made if the effect of the material differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of results. In case, there are material differences and adjustments to account for such differences deteriorates the reliability of results, such uncontrolled transactions should not be used as comparable. The real test is the reliability and integrity of results with or without adjustments. The selection of most appropriate method depends on the availability of information on uncontrolled transactions and application of standard of comparability so that reliable results are obtained. Comparability analysis assumes a crucial role in the selection and application of the most appropriate transfer pricing method in light of the facts and circumstances of the case.

1.7 Factors of Comparability

The accurate delineation of the actual transaction or transactions between the associated enterprises requires analysis of the economically relevant characteristics of the transaction. These conditions would be those which the independent parties would have agreed in comparable transactions in comparable circumstances. The comparability analysis involves two steps: The first analysis is to accurately delineate the controlled transaction by identifying the commercial or financial relations between the associated enterprises and the conditions and connected economically relevant circumstances to such a transaction. The second step involves comparison of the conditions and economically relevant circumstances of the controlled transactions with comparable transactions between independent enterprises. For identifying the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations requires a broad-based understanding of industry sector in which the MNE Group operates and the factors affecting the performance of any business operating in that sector. Rule 10B (2) of the Rules, prescribes four broad economically relevant characteristics or comparability factors to be kept in mind to test whether a controlled transaction is comparable to an uncontrolled transaction and this reads as:

"The comparability of an international transaction [or a specified domestic transaction] with an uncontrolled transaction shall be judged with reference to the following, namely:

(a)	*The specific characteristics of the property transferred or services provided in either transaction;*
(b)	*The functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;*
(c)	*The contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;*
(d)	*Conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail."*

The above shows that, Indian transfer pricing rules combine the analysis of Step 1 and 2 discussed above. It requires the accurate delineation of the international transaction and its comparison with the uncontrolled transaction based on specified factors of comparability or attributes of the transaction. It may be noted that these comparability factors are same as prescribed in paragraph 1.36 of the OECD TP guidelines and paragraph B.2.1.6 of the UN TP guidelines. However fifth factor in both the Guidelines relate to business strategies and I. T. Rules do not cover business strategies pursued by the parties to the transaction, as the same has not been explicitly stated.

As the degree of comparability increases, the potential material differences decreases making the analysis meaningful and results are reliable. On the other hand, in case of material differences, it would be necessary to make adjustments but the number, magnitude and reliability of adjustments may affect the reliability of the overall comparability analysis. Therefore, a fine balance is required to be struck so that the results do not introduce more uncertainties and change the character of transactions due to adjustments to cover the material difference. In such cases, it is better to discard such an uncontrolled transaction or independent entity as not a suitable comparable.

1.8 Documentation

The documentation ensures that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns. The documentation requirement is to assist taxpayers in demonstrating that their transactions satisfy the arm's length principle. The documentation ensures that the tax administration will get necessary information to conduct a transfer pricing risk assessment to make an informed decision whether to conduct an audit or not? The tax administration must get additional information which may not be explicitly covered in the prescribed documents but available with the taxpayer to carry out a comprehensive audit after a decision to conduct an audit is taken. To meet these objectives, Indian transfer pricing law has prescribed detailed documentation requirements on contemporaneous basis and these are briefly stated below:

- Section 92D and Rules 10D and 10DA;
- Section 286 and rule 10 DB;

Section 92D and Rule 10D mandates the taxpayer to keep and maintain comprehensive and contemporaneous documentation and this requirement will be fulfilled now by local file[3] and related documents. Accountant report in Form 3CEB contains some information in regard to local file that can be used to carry out a risk analysis. The methodology to prepare master file is prescribed in Rule 10DA. The reporting of master file related documentation is performed by prescribed entity in Forms 3CEAA and 3CEB. The country by country report (CbCR) is required to be prepared following the methodology prescribed in rule 10DB. Forms 3EAC, 3CEAD and 3CEAE deals with the CbCR. The aforesaid documentation requirements satisfy three-tiered documentation structure consisting of (i) a master file containing standardized information relevant for all MNE group members; (ii) a local file referring specifically to transactions of the local taxpayer; and (iii) a Country-by-Country Report containing information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of location of economic activity within the MNE group.

The master file, local file and also if shared CbCR and information in prescribed forms and documents that are mandated to be kept and maintained including functions performed,

[3]The obligations in regard to local file, master file and country by country reporting arose due to implementation of the recommendations in the final report on Action 13 of the G-20/OECD Base Erosion and Profit Shifting project.

assets used, and risks assumed (FAR) analysis and economic analysis prepared by the taxpayer to demonstrate that transaction undertaken by the taxpayer satisfies the arm's length conditions come handy to the transfer pricing officer during the transfer pricing assessment. The requirement

to keep and maintain detailed documentation including the obligation on taxpayer to carryout comparability analysis and economic analysis is of great assistance to the transfer pricing officer. There are clear obligations on the taxpayer/ MNE group for keeping and maintaining the prescribed documents in regard to international transactions, master file, local file and country by country reports. Penalties are prescribed to ensure compliance with the law. These requirements ensure that transfer pricing officer has access to proper and contemporaneous documents maintained by the taxpayer including the comparability analysis during comprehensive transfer pricing audit. The experience gathered during transfer pricing audits show that the comparability analysis carried out by the taxpayer is not carried out properly and lacks depth as far as delineation of the taxpayer controlled transactions are concerned and it will be necessary for the transfer pricing officer to understand the analysis provided and to check whether the same meet the requirements and if not additional analysis is required to be carried out based on comparability factors and OECD/ UN TP guidelines. These guidelines are very helpful in understanding the nuance of transfer pricing analysis.

1.9 Components of Comparability Analysis

Comparability analysis concerns two key aspects: The first is accurately delineating the controlled transaction under review; and second aspect is to compare the conditions and the economically relevant circumstances of the controlled transaction with the conditions and economically relevant circumstances of comparable transactions between independent enterprises. The provisions in regard to comparability analysis in Rule 10 B (2) are consistent with similar provisions in the OECD and UN TP guidelines and it is expected that the transfer pricing officer are well versed with these guidelines so as to ensure a proper comparability analysis which is the foundation to the proper application of transfer pricing law. Comparability analysis may not always focus on the price of the transaction or conditions of transactions but also to establish whether a transaction has taken place at all or actual transaction is consistent with what is described in contracts or documentation. Various components of comparability analysis in brief are described below:

1.9.1 Accurate Delineation of the Controlled Transaction

For application of the arm's length principle, it is necessary to first thoroughly understand the transaction(s) by identifying the substance of the commercial and financial relations between the associated enterprises and the conditions and economically relevant circumstances particularly the features of the controlled transaction(s) to be compared. The economically relevant circumstances must be accurately described. The discussion on important aspects and typical process followed in this analysis is outlined below:

- Understanding of the industry sector of the MNE group and factors affecting the performance of business in that sector and the business strategies, competition, regulatory factors, markets, products, supply chain and other elements that may affect the taxpayer business and its environment. This analysis is by nature specific to each taxpayer and industry. This information is likely be included in the Master File. This information otherwise would also be available in the taxpayer's or MNE group flagship company's annual report, news releases and news articles, research reports prepared by market analysts, interview of

management personnel, management letters, court cases, information on its website etc. These provide a reasonably fair idea of what the taxpayer and MNE group does and what type of industry it operates. It gives insight into nature of its business activities (i.e. manufacturer or distributor or licensed manufacturer etc.), its market segment, market share, industry it operates, market competition etc. For example, Form 10K filed with the Securities and Exchange Commission of the USA by stock exchange listed company contain lot of relevant information for example business, competition, group revenue, profitability, information on its operating entities and global presence, risk factors, compensation to employees including employee stock option plans, competition, disputes including concerning tax. It may be good to request annual report of the parent/ flagship company, if not available in the public domain. Sometimes, security analysts contain very useful information about the future prospects of the group. In a case of captive services provider, the taxpayer was claiming that its services are routine and employees are of average skill but the interview of managing director quoted by the analyst referred to contrary facts. MD had claimed that employees in India are involved in innovation and many patents are registered in their names.

- Operation of the particular company in the group and its commercial and financial relations with other associated enterprises of the group;
- Analysis of the economically relevant characteristics of the controlled transaction that includes conditions of the transaction and economically relevant circumstances in which transaction takes place;
- Economically relevant characteristics are the factors of comparability narrated above and the analysis is supposed to be included in the local file.

1.9.2 Contractual Terms of Transaction

- Contract between parties provide for division of responsibilities, obligations and rights, assumption of identified risks and pricing of transaction. The terms of transaction may also be found in the communication between parties other than a written contract. The written contract may not reflect the full extent of commercial and financial relations between parties. If the contract does not address characteristics of the transaction then more information based on actual conduct of the parties in regard to commercial and financial relations requires to be obtained. Where characteristics of the transaction that are economically significant are inconsistent with the written contract then actual transaction must be delineated based on the characteristics of the transaction reflected in the conduct of the parties.
- The contract/ agreement between associated enterprises in many of the cases do not provide information on commercial and financial relations explicitly because divergence of interests may not exist in the case of associated enterprises as is possible in case of independent parties or any such divergence may be managed through control relationship. There is little likelihood of any dispute between associated enterprise due to contract being silent on any issue. It is very common to lay hands on agreements that have retrospective operations. Those may not be dated by the signatory of foreign party. It is also common to have no information on various material aspects that are must in agreements with independent enterprises and these for example can be sales and purchase volume, information on placing

orders, prices, delivery terms, credit terms, rights to revision and modifications, termination Clause and consequences of termination etc.

- Associated enterprises may not follow the terms and conditions and may not hold each other fully to the terms of the contract since they have common interests and internal instructions/ directions may decide the actual relationships in the transaction.
- When there are material differences between contractual terms and actual conduct of related parties in their relations with one another, the functions they actually perform, the assets they actually use, and the risks they actually assume, should determine the factual substance and accurately delineate the transaction.
- In case a transaction is not formalized through an agreement, all aspects would need to be deduced from available evidence of conduct of parties including what functions are actually performed, what assets are actually used and what risks are actually assumed by each of the parties.
- The transactions of market support services are classic example. The Indian subsidiary may be engaged in buy-sell (trading activities) but the foreign associated enterprise makes direct sales to customers in India as they can claim import duty benefits due to government policies like SEZ/ STPI units. It has been found that all activities in regard to sales are performed by employees of subsidiary but invoices are issued by foreign company to the customer. The services provided by subsidiary are termed as marketing support services. But there is no marketing by the foreign entity in India and therefore there is no question of support. It has been observed that employees of subsidiary perform identical functions in regard to trading and sales and decision to raise invoice is taken in last so that customers can avail import duty benefits. The employees also have power to provide discounts based on what is called "authorization matrix". On the other hand, agreement will always explicitly have a mention that employees of Indian subsidiary have no powers in regard to price negotiation and this exactly opposite of what they do. This is a case of contract not being consistent with the actual conduct.
- The transaction as accurately delineated may be disregarded (not-recognised), and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by the independent enterprises behaving in a commercially rational manner in comparable circumstances. An arrangement that is expected to leave the MNE group as a whole worse off on a pre-tax basis than it would be as if it had not entered into the arrangement may require proper examination and to understand whether it is commercially irrational. Care should be taken not to disregard the rational transactions even though it may not be seen in case of independent parties. All the transactions that might be interconnected must be examined before disregarding a transaction between associated enterprises. Substitution of transaction should be undertaken in extreme cases and when fully justified otherwise it will create uncertainty to taxpayers and tax administrations and may result into a possible double taxation.

1.9.3 Characteristics of Property or Services

- Characteristics of property or services affect the value/ price of the same in open market. Differences in the specific characteristics often account for differences in their value/ price.

- These characteristics in the case of tangible property may be physical features of the property, quality, reliability, availability and volume of supply.
- In the case of services, nature and extent of such services is important.
- In case of intangible property- form of the transaction- licensing or sale; type and form of property (i.e. patent, trade mark, know-how, brand name); duration and degree of protection; exclusive or non-exclusive, terms and conditions, territory of grant, and the anticipated benefits form the use of property, enhancement of brand value etc.
- The weightage to characteristics of property or services depend on the use of transfer pricing method. The comparability is the strictest for the application of comparable uncontrolled price method, as prices are considered and compared.
- The strict similarity may not be required in the application of resale price method and cost-plus method as the resale margin or mark-up on cost may not to be materially affected due differences in characteristics of property and services. The same is the situation for application of transactional net margin method. For application of profit-based method similarity of functional characteristics are more relevant.
- However, application of any method does not rule out comparison in characteristics of property and services fully because totally different services or property will entail different functions performed, assets used and risks assumed by the parties and will affect the remuneration.
- In the application of traditional methods of cost plus or resale price method and also profit based methods, one need not to compare similarity of products but functional similarity. But, products dealt with or nature of services should not be so different that changes the industry itself and results based on uncontrolled comparable become unreliable.

1.9.4 Functional Analysis

- Compensation to an enterprise in the transaction between independent enterprises depends upon the functions performed taking into account assets used and risks assumed by the enterprise.
- Analysis of functions performed, assets employed, and risks assumed by associated enterprises to the controlled transaction is called functional analysis (also called FAR analysis).
- A functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken by the associated and independent enterprises. An economically significant activity is one which materially affects the price charged in a transaction or the profits earned from that transaction. Economically significant function adds more value to the transaction and entity performing those functions is expected to fetch higher anticipated returns.
- A functional analysis is a process of finding and arranging economically significant facts about the transaction in terms of the functions, assets, and risks and how are these divided between the parties to the transaction. More valuable the functions performed, assets used, and risks assumed by a party in the transaction entitles it to a greater expected remuneration.
- The functional analysis focus on activities of the parties to the transaction and capabilities they provide including capabilities for decision making for example about business strategies and risks.

- It is important to understand how value is generated by the group as a whole and contribution the enterprise make in the value creation.
- To know legal rights and obligations of each party to the transaction.
- Consideration of capabilities of the parties to the transactions is important because that will determine the options realistically available and whether similar capabilities are available in the potentially comparable uncontrolled transactions/ entities
- In case of service providers entities, it would be appropriate to have analysis on the employee's qualifications, skills, experience, certifications required, previous employers, their incentives whether dependent on the profitability and revenue of Indian company or parent, contributions in innovation, automation, data analytics, use of specific tools, databases, frequency of travel and purpose of travel, composition of teams, grades and number of employees in India and other locations are very important characteristics of resources used and help identify proper comparable.
- It is necessary to identify tangible and intangible assets used and contributed by the parties in the transactions.
- Whether MNE Group has fragmented highly integrated functions across several group entities and those activities performed by different entities of the MNE Group are interdependent and to what is the nature of such interdependencies and how the commercial activities between different entities are coordinated.
- Information available due to functional analysis also helps in the identification of potential comparables, as the search for such comparables will focus on uncontrolled transactions that have a similar allocation of functions, assets, and risks between the parties.
- Functional analysis helps then to select tested party, most appropriate method and finally whether the profits (losses) earned by the entities satisfy the arm's length principle and are appropriate to the functions performed, assets employed and risks assumed.

1.9.5 Analysis of Risks in Commercial and Financial Relations

- Risks are an inherent part of any business. Commercial activities are undertaken to earn profits. The risk is the effect of uncertainty on the objectives of the business. Profit seeking enterprises would only take on risks associated with commercial opportunities if they anticipate positive return. But opportunities are inherently uncertain and actual results may be better or worse.
- Firstly, economically significant risks must be identified and then which entity assumes which risks and to what extent.
- The purpose of risk analysis is to compare the risk assumed by the associated enterprise in comparison to the independent party. An associated enterprise assuming a risk comparable to the independent party also performs risk management functions comparable to that performed by the independent party.
- Identification of relevant and economically significant risks is done along with the identifying functions and assets in the transaction. What are the economically significant risks in the transaction between associated enterprises is the most important step for risks analysis.
- Identification of risks in a transaction may be difficult in comparison to functions and assets and therefore very careful analysis is required.

- In regard to risks the analysis should include: identify economically significant risks; how are these risks contractually (under terms of the transaction) assumed; how do the parties operate, control functions, risk mitigation functions, up/ down side consequences, financial capacity (which enterprise assume and manage the risks, which enterprise perform control and mitigation function, which enterprise suffer or gain due to risks and which enterprise has financial capacity to assume the risk); whether the contractual assumption of risks is consistent with the conduct of the parties to the transaction; whether the party assuming the risk exercises control over the risk and has the financial capacity to assume the risk.
- The significance of a risk depends on a combination of its likelihood of occurrence and potential impact on the profits (or losses) of the business.
- Risks assumption means bearing consequence of the risk. Party assuming a risk will bear the financial and other consequences if the risk materializes. This may be set out in the written contract.
- Financial capacity to assume risk denotes that party have funds to take on the risk or lay off the risk, to bear risk mitigation expenses and bear consequences of the risk if that materializes.
- Control over risk indicates the capability to make decision about taking or laying off or decline a risk bearing opportunity together with the actual performance of that decision-making function; the capability to make decision on how to respond to the risks and actual decision-making function; and performance of risks mitigation functions either by itself or outsource and take decision about outsourcing. Control over risks involves the process of real decision-making. The real decision making is possible by technically and functionally competent persons and they should have capability to make those decisions.
- To exercise control over a risk requires both capability and functional performance.
- Risk mitigation involves measures to affect the risk outcome. Measures that reduces the uncertainty or risk or reduces the downside impact of the risk.
- Some of the common risks that require proper analysis are: strategic risk or market place risk; infrastructure or operational risks; financial risks; transactional risks; and hazard risk.
- In a comparability analysis, where potential comparables are identified, it is relevant to determine whether they have the same level of risks and management of risks.
- It is important for the tax administration to know from the contemporaneous documents (ex-ante) a commitment of a party to assume risk prior to the materialization of risk outcomes. As the audit takes place after the risks have already materialized and results are known, a stand not supported by clear evidence of a commitment to assume a risk prior to the materialization of risk outcomes may not be acceptable. Many of risks may not materialize. It cannot be claimed that some risks, which did not materialize, were assumed by other party which were not agreed beforehand, so as to allocate more profits to other party. Similarly, re-allocation of risks by the tax administration after risks outcome are materialized may also not be proper.
- The form of remuneration cannot dictate inappropriate risk allocations. How the parties manage and control the risks will determine the assumption of risks by the parties. For example, it will not be proper to claim that foreign exchange risks are

assumed by other party to the transaction when in practice the gain or loss from the fluctuation of foreign exchange rate is never passed on the other party and the party also hedge the transactions.

- It is of utmost importance to carry out functional analysis in relation to economically significant risk and this involves determination of which enterprise or enterprises perform control functions, risk mitigation functions, and which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise has financial capacity to assume the risk.
- In the functional analysis relating to risks, the information regarding assumption and management of risks require to be interpreted and then checked whether the contractual assumption of risks is consistent with the conduct of the parties and whether the party assuming the risk exercise control over the risk and has the financial capacity to assume the risk. The claim that product liability risks in regard to products supplied by a foreign associated enterprise is borne by the foreign party may not be correct in the circumstances when there are hardly any product failure and in case of any rare failure the products, the same are imported by the Indian distributor and provided free of cost to the customer. In this case risk is borne by Indian distributor.
- It is likely that contract between associated enterprises may not specify the allocation of all economically significant risks. It will be duty of transfer pricing officer to identify economically significantly risks and analysis of who have assumed in practice.
- If an associated enterprise assuming the risk does not exercise control over the risk or does not have financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk.
- Financial capacity to assume a risk can be defined as access to funding to take on or lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if it materializes.
- It is possible than an associated enterprise only performs control function in relation to a risk but does not assume the risk, compensation will be in the form of sharing in the potential upside and downside, commensurate with that contribution to control of risk.
- Contractual assumption of risk and actual assumption of risk determined based on control over the risk and the financial capacity to assume risk and then risk allocation based on actual conduct is essential part of the functional analysis. This is not easy and must be performed where taxpayer is making a claim based on risk assumption or vice-versa.
- Making adjustments on account of differences in assumption of risks is difficult. The taxpayers involved in providing captive services to their parent company claim that they are risk free and this claim needs to be examined from the angle of what are all risks in the provision of services and who assumes those. For example, the main resources to provide services are employees and all risks in regard to the same including ramping up and down their numbers are assumed by the service provider. Further, by implementing the service requirement criteria like timeliness of services and error free services by taking all mitigation measure, it is not difficult to state that risks of operational nature are assumed by Indian service providers. Further, intangibles developed if any are passed on to the parent without any remuneration, which no third party

will do so. This itself balances the effect of adjustments on account of risks. Any claim of risk adjustment must be examined thoroughly before agreeing for it.

1.9.6 Economic Circumstances of the Transaction

- The prices of same products or services may not be same in different markets and depend on various economic factors. For example, cost of production, purchasing power and prevalent habits etc. For example, price of a tangible product during a particular period may not be same in Germany and India.
- Relevant economic factors affecting market comparability include the geographic location; the size of the markets; level of the market (e.g. retail or wholesale); competition in the markets and the relative competitive position of buyers and sellers; availability of substitute goods and services, levels of supply and demand in the market, consumer purchasing power, nature and extent of government regulations of the market, government incentives, location specific cost of production including cost of land, labour, capital and transport costs, period of transactions etc.
- The existence of a cycle (e.g. economic, business, or product cycle) is an important economic circumstance and should be identified and this can be done based on the available reports say of analysts/ economists. For example, the monsoon affects the availability of agriculture-based commodities and also purchasing power of customers in rural areas and is an important factor affecting prices of products and profitability of entities operating in agriculture sector in different years.
- The geographic market is also an important economic condition. Whether market is homogeneous or heterogeneous and may affect the prices in different markets. It is difficult to evaluate differences between geographic markets and corresponding appropriate comparability adjustments. Issues may arise due to cost savings attributable to operating in a particular market. The net cost savings that an MNE realise as a result of re-location of operations from a high-cost country to a low-cost country are referred as location savings. In case location savings are not passed on to independent customer or suppliers, the net retained savings would require to be allocated to the members of the MNE group participating in the transaction. Net cost savings means cost savings minus the extra cost incurred (cost dis-savings) say due to higher cost of infrastructure like shortage of and less reliable power supply, transportation cost, lower efficiency of workforce and extra cost incurred to ensure desired quality control.
- Differences in geographic market can also be due to location specific benefits and these are on account of larger customer base with increased spending capacity, availability of specialized skilled manpower and knowledge ensuring quick ramp up and ramp down of resources, market premium, opportunistic pricing, lack of competition etc. The combined effect of location savings and other location specific benefits are termed as location specific advantages (LSAs). The increased profit derived due to LSAs is called as "location rent". In case there is competition in the market then the MNE may pass on benefits to the customers in the form of reduced prices but when there is no competition and the MNE exclusively enjoys the monopoly in the market then it may derive additional profits due to opportunistic pricing. This competitive advantage may dissipate over a period of time due to competitive pressure, depending on the

facts and circumstances of the case. The non-competitive environment and specific category of product, say latest technology, fetch high price in the market and earn bumper profit due to opportunistic pricing. Such a market cannot be compared for business facing huge competition and price pressure. In this case margins would be thin. These two market features make a lot of differences and are not comparable.

- For achieving comparability, it is necessary that the markets in which associated and independent enterprises operate do not have differences that have a material effect on price or in case of material differences appropriate adjustment can be made. This is an important issue in the functional analysis, and TPO needs to be careful because sometimes taxpayers propose using data of other countries even in cases where tested party is Indian company. For the reasons of differences in market conditions that have material effect on prices, and for such differences it is difficult to work out the effect on prices and make adjustments therefore use of data from other countries/ geographies in the economic analysis should be avoided. We always come across a question that why operating margins in India are high and taxpayers argue that these should be same as say in European market. For example, mark-up on cost for arriving at arm's length prices for provision of services in Europe is about 5% whereas in India say 18%. This difference is obvious due to differences in economic conditions like interest rate (cost of capital), inflation and cost base. For example, annual salary increase in Europe may not be more than 2% whereas about 10% raise is common in India. We explain taxpayers that arm's length price is not mark-up but price as such. The cost of providing services in India might be not more than 40% of cost in European market.

1.9.7 Business Strategies

- Objective of business strategies of an MNE group is to improve its market shares and thereby overall profitability.
- Transfer pricing guidelines identify various business strategies of enterprises like innovation and new product development, degree of diversification, risk aversion, assessment of political change, duration of arrangements, impact of existing and planned labour laws, and various factors that affect daily conduct of business. The business strategies are required to be taken into account in determining the comparability of controlled and uncontrolled transactions and enterprises.
- Market share improvement strategies considered by MNEs can be divided into three main categories depending on its period of operation/ presence in a country: market penetration strategy; market expansion strategy; or market maintenance strategy. These strategies are implemented using two fundamental tactics: lowering the price of their product on a temporary basis by giving discounts so as to make them highly competitive and encourage the customers to purchase their products in preference to others; and increasing their marketing and selling expenses by increased advertising, marketing and sales promotion activities like offering rebates, free samples, offering extended warranties. It may be noted that discount sales are often announced by all competitors at the same time in developed markets and this is happening in India too. This may also include increased marketing activities such as increasing sales outlets, strengthening distribution channel and increased commission to agents and distributors.

- Many multinational enterprises are entering Indian market. An MNE group seeking to penetrate a market or to expansion or defend its market share employ different strategies. The products may be consumer goods or industrial products. Most of them implement market penetration or market share expansion schemes. These can be in the form of pricing of products or marketing spend or both. Prices charged might be lower than the prices charged for otherwise comparable products in the same market. This is done to capture market share of others. The marketing penetration or expansion strategy often is accompanied by unusually intensive marketing and adverting efforts. The example of Amazon and Flipkart to resort to heavy discounting of products sold on their marketing platform is one example of market penetration and expansion strategy.
- It is important to analyze who is taking decisions about strategy, who is bearing the cost of business strategy and who will be beneficiaries of these strategies. It is important to establish the contractual relationship based on the contemporaneous documentation and to compare how the third parties in similar situations would behave. For example, a third-party distributor with a long-term contract may agree to spend part of its revenue as marketing and advertising expenditure but this will not happen if the contract is short term and non-exclusive. The distributor with a long-term contract benefits from market development and will agree to bear the cost of market penetration strategy. The issues regarding responsibility of market development are important comparability factors and must be examined thoroughly.
- The arm's length nature of business strategy pursued by an enterprise or MNE group requires to be examined from the point of view of what a third party in similar situation and model of remuneration would do. For example, a particular market penetration or business strategy is not giving the desired results or has failed then the issue would be whether it has been stopped considering that a third party would do this. If this is continued, then there would be question about arm's length remuneration and who should bear the cost of such a strategy.
- *As mentioned earlier this factor of business strategies business strategies pursued by the parties to the transaction, is not covered under the I.T. Rules as the same has not been explicitly stated.*

1.9.8 Loss Making Enterprise

- We may come across cases where an associated enterprise doing business in the country make consistent losses for a long period of time whereas the group is profitable. This is possible when an MNE group may need to produce a full range of products or services in order to remain competitive and realise an overall profit. The group may require to establish its presence in all countries of relevance so as to serve its clients that may be doing business in those countries. If the group does not establish in a country due to small volume of business then it is likely that whole business may move to a competitor. Another situation can be when the company has moved to higher version of products but still may require to manufacture parts of discontinued products by the subsidiary to service customers using those products. In such cases, as the group benefits from the existence of loss making entity, such an entity requires to be compensated by the MNE group. It is not unusual to come across transactions like network service fee or subvention fee by the parent to its

subsidiary making loss because that loss may be not real.

- An entity may also incur loss during its startup phase or while it is pursuing a market penetration or market expansion strategy but losses would be for a limited period. The losses may also be due to introduction of new products or services or to discourage potential competitors but there need to be specific objective of improving profits in longer term. Transfer pricing examination will be required if losses persists for a longer period that what would be expected in the case of a comparable uncontrolled case.

1.9.9 Local Market Features

- The availability of local country infrastructure, the relative availability of a pool of educated, skilled, and trained workers, access to a large market, lack of competition providing opportunities for premium or opportunistic pricing are also important features of market to be considered in the comparability analysis. Appropriate comparability adjustments may be required in such cases. For example, an enterprise resorting to premium pricing will have arm's length margin more than earned by entities who operate in a different product and price ranges. However, in case comparable transactions in a local market can be identified and used in the economic analysis, specific adjustments for local market features may not be required to the extent specific features in the controlled transactions are also affecting the transactions undertaken by the independent parties. Where local market comparables cannot be identified, it would be necessary to examine the existence of market advantages or disadvantages and effect of the same would require to be considered in the economic analysis.

1.9.10 Assembled Workforce

- In some situations, say business restructuring or transfer of business, the assembled workforce (employees of the taxpayer) may be in itself an intangible or enhance the value of intangible or other assets and this would be an important element of transfer pricing analysis. Similar issue may arise in the transfer or secondment of one or more employees and such transfer depending on facts may result in the transfer of valuable know-how or other intangibles from one associated enterprise to another. Such a transfer of intangible will require compensation at arm's length.

1.9.11 Performing a Comparability Analysis

- After the analysis of taxpayer-controlled transactions (delineation of controlled transaction) and the comparability factors (economically relevant characteristics) is done, then the search for information on potentially comparable uncontrolled transactions or independent entities will take place.

- It is necessary that a methodical and consistent approach is followed in the whole of analytical process involving delineation of controlled transaction, examining of factors of comparability, selection of transfer pricing method, and identification of potential comparables and ultimately a conclusion about whether the controlled transaction complies with the principle of arm's length. This whole process is linked and cannot be completed in isolation. For example, the application of a particular transfer pricing method would be dependent on the nature of controlled transaction and availability of information on comparable uncontrolled transactions.

- The purpose of identifying comparable uncontrolled transaction is to zero on the most reliable comparable and the process will involve eliminating uncontrolled transactions that have lesser degree of comparability with controlled transactions than others.
- It is not necessary that all possible sources of data are searched but at the same time nothing of known sources are left out.
- There are conflicting interests of taxpayers and tax administration, it is our experience that taxpayer search process will identify uncontrolled transactions or enterprises that justify satisfaction of arm's length principles by controlled transactions and supports its transfer pricing. On the other hand, the tax administration uses comparable to support a transfer pricing adjustment.
- It is necessary that search methodology is disclosed to other party by either of the parties mentioned above.
- The process for identification of comparable should lead to identification of reliable comparable. The reliability of comparable is more important than the process.

1.9.12 Process for Identification of Comparable(s)

- The experience shows that taxpayers normally use three commercially available Indian databases: Capitaline, Prowess and ACE TP database for identification of comparables. These databases have information based on the annual report of the companies. In the case of companies whose shares are traded on stock exchange, information provided by the companies as per disclosure requirements are also used in the databases.
- These databases have information on about 30,000 to 35,000 companies in various years.
- The above databases are useful in the transfer pricing analysis wherein the Indian taxpayer is considered as tested party.
- It may be noted that these databases are prepared for non-transfer pricing purposes and primarily meet the requirements of analysts in the financial service industry and people dealing in the financial markets. In absence of any suitable source of financial information on companies these databases have been used by taxpayers in their transfer pricing analysis and have been accepted by the tax administration. These databases are only useful when analysis is based on segment or entity level results. The transaction-by-transaction analysis is not possible. For example, taxpayer having controlled transaction of import of raw material. These databases do not provide information on pricing.
- For the application of cost-plus method, re-sale price method and transactional net margin method the information on financial indicators of uncontrolled companies is required. The identification and selection of reliable external comparable can be done by following a systematic methodology consisting of steps like: examination of factors of comparability for the controlled transaction, development of search criteria to take into account distinguishing features of the controlled transaction, identifying potential comparable, qualitative analysis of each identified potential comparable in the light of functional analysis of the controlled transaction.
- After a new comparable (other than used by the taxpayer) is identified based on the above process, it would be necessary to confront the taxpayer with this information and it should be asked the reasons for

rejection of the same in its search process. It should also be asked to make a list of comparable that were used in the analysis for say last five years. Experience shows that an entity with high operating margin is generally excluded in one year for any reason but the same entity will be used as a comparable in other year if its margin is low in that year. There needs to be consistency in approach and reasons for selection/ rejection of a comparable. It will be good to request the taxpayer to submit a strength and weakness analysis in respect of all comparable selected by it and proposed by the transfer pricing officer. This will enable the transfer pricing officer to analyze the contrary and conflicting position/ arguments of the taxpayer and selection of real comparable. Reliability of analysis is the prime requirement and the comparable used should not make the result unreliable. It is better to use less number of near real comparable then using large numbers that reduces the reliability and whole purpose of transfer pricing analysis is defeated. It needs to be noted that if an entity which is not a real comparable is selected in the analysis it will defeat the purpose of whole exercise of comparability analysis.

- Another issue is non-availability of comparable independent enterprises or lack of reliable comparable with respect to the transactions. It is not a secret that MNEs mostly operate in businesses that are dominated by MNEs only and in most of the businesses competition is between multinational groups only and there is hardly any competition from domestic player. Information on independent transactions or independent enterprises may be scarce and imperfect in certain industries dominated by multinational enterprises. Since it is very difficult to face competition from MNEs who can use their financial prowess to kill competition, it is very common that MNE keep acquiring domestic businesses that poses competition or meet its synergy requirements. Due to these reasons, it is difficult to find reliable comparable transactions or comparable entities.
- Due to these factors, information on comparable entities may not be available and there would be difficulty in applying profit-based methods. If information on the independent transactions or enterprises is not available, it will be necessary to look for suitable method that may be applied. For example, transactional profit split method may be considered as the method in appropriate circumstances that does not require information on comparable data for its applicability. In case information on transactions undertaken by independent enterprise similar to controlled transaction is not available then the application of arm's length principle would be difficult except exploring the feasibility of application of profit split method or to examine the economic substance of the transaction to determine whether its conditions are such that it might be expected to have been agreed between independent enterprises in similar circumstances- in absence of evidence of what independent parties have actually done in similar circumstances.
- It may also be noted that absence of a transaction undertaken by independent enterprise does not of itself mean that controlled transaction is not at arm's length or is at arm's length.
- Without going in the legal issue of whether an associated enterprise to the transaction located outside India can be used as tested party, it would be necessary to use databases containing information on companies of that jurisdiction/ geography if the foreign party is chosen as a tested party. There is

no harm in choosing a foreign associated enterprise as a tested party when results of analysis are more reliable then what would have been had the Indian taxpayer was chosen as a comparable.

1.9.13 Approach to Identifying Potential Comparables

- The identification of potential comparables based on the search of commercial databases is called the deductive approach and has been used by the taxpayers and tax administration in India. This is not discussed in this chapter.
- Another approach for identifying potential comparables is additive approach. In the additive approach a list is prepared of potentially comparable uncontrolled transactions or of independent enterprises which are considered to be having similar functional profile. These may be companies in the relevant industry sector. Then information is collected on the entities so as to establish whether the company identified is comparable or not and this is done based on the application of comparability factor tests discussed above.
- Potential comparables based on additive approach can be identified based on vast information available on the internet. Such information is available even free of cost to everyone including taxpayers, their consultants and tax administration. Some of these sources are: members of industry associations, reports of market and industry analysts, reports on competitors and market share, stock exchange websites, information on peers for example available on the websites of Economic Times or Bloomberg, previous employers of employees in case of lateral recruitment, cases of infringements of patents/ copyrights by the MNE group, orders of the Special Valuation Branch of the Customs etc. It may be noted that shortlisted companies will require to undergo examination based on the comparability factors so as to satisfy that they have functional profile similar to the controlled entity.

1.9.14 Transfer Pricing Analysis

- Analysis involves based analysis of the taxpayer circumstances and MNE group; delineation of the controlled transactions and detailed examination of functional analysis; availability and examination of information on internal and external comparables; identifying sources of information on external comparables; selection of most appropriate method considering the available information on uncontrolled transactions/ enterprises and other factors; determination of appropriate financial indicator (profit level indicator), identification of potential comparables; examination of potential comparable for identifying differences that can materially affect prices or profits and then making adjustments to account for these differences; interpretation of data of comparable with that of the taxpayer to arrive at conclusion on arm's length remuneration. The whole process of functional analysis, selection of most appropriate method, and identification of potential comparable transactions or enterprises is not linear but involve lot of iteration so as to reach to a satisfactory and reliable conclusion.
- Broad based analysis of the taxpayer and MNE group involves analysis of the industry, competition, market size, market features, economic and regulatory factors etc. and this helps in the identification of potential comparable enterprises in case transfer pricing analysis warrant testing of transactions at entity level.

- The arm's length principle requires to be applied ideally on a transaction-by-transaction basis but aggregation of transactions is also possible should the facts and circumstances require and, in the circumstances, that transactions are interrelated and closely linked and transaction-by-transaction analysis may not lead to a reliable result. Further, aggregation of transaction may become a practical necessity when information on the comparable transactions in case of independent enterprise is not available. Further law now (i.e. from assessment year 2015–2016) provides using multiple-year data of comparables so as to take into account volatility in the business.
- As far as selection of tested party, selection of most appropriate transfer pricing method, selection of comparable and many other important issues are concerned, the same are not in the scope of this Paper and the guidance and jurisprudence should be used.

2. CONCLUSION

The purpose of this chapter is to highlight the importance of the delineation of controlled transaction and functional analysis in the transfer pricing analysis by the taxpayer and tax administration. There is asymmetry of information available with the taxpayer and tax administration. The taxpayer has all the information on transactions but tax administration will have only that information requested from taxpayer therefore there should be no hesitation in requesting relevant information. The adjustment to price or profitability of controlled transaction(s) should be based on robust analysis of facts and deficiencies in the analysis of the taxpayer should be explicitly brought out in the transfer pricing assessment so that it is able to withstand all sorts of onslaughts during the appellate proceedings. All officers and not only those involved in the transfer pricing audits are encouraged to read the UN and OECD TP guidelines. India, China, Brazil, South Africa, and Mexico have given their country practices in the UN TP Manual. Practices in other countries also give an insight into issues in other countries which are at the similar level of development. These should also be studied by the officers.

CHAPTER

3

Taxability of Income Arising from Liaison Office (LO) of a Non-Resident

1. TAXABILITY UNDER THE INCOME-TAX ACT

1.1 As per Section 9(1) of the Income-tax Act ('Act'), all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India is deemed to arise in India. Explanation 1 to this Section provides some exclusion, as under:

a. In the case of a business of which all the operations are not carried out in India, the income of the business deemed under this Clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India;

b. In the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export;

c. In the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India.

1.2 Thus, any income accruing or arising to a Liaison Office (LO) of a non-resident is subjected to tax in India under the Act, unless (i) it is through or from operations which are confined to the purchase of goods in India for the purpose of export; or (ii) in case of a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, it is through or from activities which are confined to collection of news and views in India for transmission out of India.

2. TAXABILITY UNDER THE DOUBLE TAXATION AVOIDANCE AGREEMENT (DTAA)

2.1 If the non-resident is a resident of a country with which India has a Double Taxation Avoidance Agreement (DTAA), then the income accruing or arising from the LO would be taxable in India only if it is also taxable under the DTAA as well. It is a settled law that the assessee is entitled to more beneficial provisions of domestic income-tax Act and DTAA. Thus, the income must be taxable both under the Act as well as the applicable DTAA, before India can exercise its taxation right.

2.2 The concept of Permanent Establishment (PE) finds its place in the DTAA for taxation of business income of non-resident in the source country. Let us assume that a nonresident (who is resident of UK) is carrying out business in India. In this case the resident country is UK and source country is India. DTAA allocates taxation rights between resident country and source country under different situations. For business income, the taxation right is given to source country only if the nonresident enterprise, carrying on business, has a PE in the source country. The exceptions are income of the nature of royalty, interest, dividend and fees for technical services (FTS) which may be taxed in the source country even in the absence of a PE. Different Articles of DTAA govern taxation of royalty, interest, dividend and FTS in the source country without there being a PE. Text of these Articles would differ across DTAAs and one needs to go through the text carefully. However, for the topic being discussed here, we need to concentrate on business income other than royalty, interest, dividend and FTS.

2.3 Normally, Article 5 of the DTAA deals with PE. This Article generally states that, PE means a fixed place of business through which the business of the enterprise is wholly or partly carried on. There are a few tests to be passed before any place, equipment, facility; etc can qualify to be a PE. These tests would generally be satisfied in the case of LO; if it is in operation for reasonable period of time and it is at the disposal of the nonresident who carries out its business through it. However, all DTAAs (in the same Article 5) also provide exclusions from PE to certain activities which are preparatory or auxiliary in character and which are listed in the respective DTAAs. Although the text of each DTAA would differ, but generally the exceptions from PE are provided as under:

a. *The use of facilities solely for the purpose of storage, display or occasional delivery of goods or merchandise belonging to the enterprise;*

b. *The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or occasional delivery;*

c. *The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*

d. *The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or for collecting information, for the enterprise;*

e. *The maintenance of a fixed place of business solely for the purpose of advertising, the supply of information, scientific research, or any other activity, if it has a preparatory or auxiliary character in the trade or business of the enterprise;*

f. *The maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e) of this paragraph, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*

2.4 Thus, the above activities would not constitute PE, even though these activities are

carried out through a fixed place like LO. The commentary state that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in question. It is for this reason they have been excluded from the definition of PE. In general, nonresidents claim that their LOs fall under the above exclusion; and hence they do not have PE in India. In support of their claim they submit that LO is only a representative office of the nonresident and the RBI has permitted it to act only as a communication channel between the nonresident and the parties with the RBI's restrictions, in the permission letter, listed as under:

i. Except the proposed liaison work, the office in India will not undertake any other activity of a trading, commercial or industrial nature nor shall it enter into any business contracts in its own name without our prior permission.

ii. No commission/ fees will be charged or any other remuneration received/ income earned by the office in India for the liaison activities/ services rendered by it or otherwise in India.

iii. The entire expenses of the office in India will be met exclusively out of the funds received from abroad through normal banking channels.

iv. The office in India shall not borrow or lend any money from/ to any person in India without our prior permission.

v. The office in India shall not acquire, hold, (otherwise than by way of lease for a period not exceeding five years) transfer or dispose of any immovable property in India without obtaining prior permission of the Reserve Bank of India under the Foreign Exchange Management (Acquisition and transfer of immovable property in India) Regulations, 2000.

vi. The office in India will furnish to our Regional Office (on an yearly basis) a certificate from the auditor that the office has complied with the terms and conditions stipulated in the letter of approval issued by the Reserve Bank of India and that all the expenses are met by way of inward remittances. In the case of winding up of the office, you may approach Regional Office with the documents as required in terms of Regulations 6(1)(iii) of Notification No. FEMA.13/ RB-2000 dated 3rd May 2000.

vii. The office in India will not render any consultancy or any other services directly/ indirectly, with or without any consideration.

viii. The office in India will not have any signing/ commitment powers, except than those which are required for normal functioning of the office, on behalf of the Head Office.

ix. In case you desire to open a Head Office account in the books of your liaison office in India, we hereby grant you our approval to maintain such an account subject to the conditions that the credits to the account should represent the funds received from Head Office through normal banking channels for meeting the expenses of the office. Debits to this account could be raised only for meeting the local expenses of the office.

x. The activities/ affairs of these offices may be verified/ examined by RBI by carrying out a scrutiny as and when found necessary.

xi. Please note that you shall have to obey the law of the land and there shall be no compromise or excuse for the ignorance of the Indian legal system in any manner.

2.5 It is also important to look at Regulation 2(e) of Foreign Exchange Management Act (in short FEMA) 2000 which defines LO as follows:

"(e) Liaison office means a place of business to act as a channel of

communication between the principal place of business or Head Office by whatever name called and entities in India but which does not undertake any commercial/ trading/ industrial activity, directly or indirectly and maintains itself out of inward remittances received from abroad through normal banking channel"

2.6 Further, schedule II to the FEMA, read with Regulation 6(1), gives the following list of activities, which can be carried on, through a LO:

i. "Representing the parent company/ group companies in India.

ii. Promoting export/ import from/ to India.

iii. Promoting technical/ financial collaboration between parent/ group companies and Indian companies.

iv. Acting as communication channel between parent and Indian companies."

2.7 Thus, the nonresident (resident in one of the Indian treaty countries) claim that it's LO is performing only those activities which are permitted to it by RBI and are in accordance with FEMA regulation. They further claim that since these activities are preparatory or auxiliary in character and are included in exclusion Clause of DTAA, there is no PE in India. As an investigating officer we need to find out (i) whether the LO is performing activities beyond what has been permitted by RBI and (ii) even if the activities are within the permission granted by RBI, can they still be called preparatory or auxiliary?

3. WHETHER LO IS PERFORMING ACTIVITIES BEYOND WHAT HAS BEEN PERMITTED BY RBI?

3.1 In case the LO is performing activities which are within the parameter laid down by RBI read with FEMA regulation then, except for the situations discussed later, the income from LO would not be taxable under the DTAA as there would not be a PE. There are many judgments where the court/ ITAT held that as long as LO is performing activities permitted by RBI as liaison activities, they would be covered under the exclusionary Clause of PE and hence there will not be any PE. In some judgments, the reference to RBI permission may not be there but it was held that the work carried out by LO was only of communication of information and as a representative office and hence, the activities would be covered under exclusionary Clause and would not create PE. Some of these judgments are:

- *IAC vs. Mitsui & Co Limited* (1991) 39 ITD 59 (ITAT Del) (SB). The decision was followed by the ITAT in *DCIT vs. Sofema SA* 2006-TII-42-ITAT-Del-INTL to hold that the LO did not result in a PE. This case went uptil SC where SC dismissed revenue's appeal 2008-TII-09-SC-INTL.
- *Sumitomo Corpo vs. DCIT* (2007) 110 TTJ 302 (ITAT Del).
- *CIT vs. Visakhapatnam Port Trust* (1983)144 ITR 146 (AP HC).
- *Gutal Trading Est, In re* (2005) 278 ITR 643 (AAR).
- *Motorola Inc & Others vs. DCIT* (2005) 95 ITD 269 (ITAT Del SB).
- *Western Union Financial Service Inc vs. ADIT* (2006) 101 TTJ 56 (ITAT Del), followed in *DDIT vs. Western Union Financial Services Inc* (2012) 50 SOT 109 (ITAT Del).
- *Sojitz Corporation vs. ADIT (2008)* 117 TTJ 792 (Kol).
- *DCIT vs. Tokio Marine & Fire Insurance Co Ltd* 2008-TII-05-ITAT-DEL–INTL.
- *Airports Authority of India, In re* (2008) 299 ITR 102 (AAR)
- *UAE Exchange Centre Limited vs. UOI* (2009) 313 ITR 94 (Del HC).

- *KT Corporation, In re* (2009) 224 CTR 234 (AAR)
- *Metal One Corpn. v. DDIT* [2012] 22 taxmann.com 77 (ITAT Delhi).

3.2 The activities involved in above judgments were of the following nature:

- Acting as a communication channel between the nonresident enterprise and the Indian clients;
- Supplying information to Indian clients of nonresident enterprise to clear doubts before final conclusion of contract;
- Communicating information about payment schedule, mode of transport, freight and charge, bank guarantee, interest payable, commission payable etc.
- Communicating to head office information about potential buyers, potential sellers, response of the Indian market, collecting bid/ tender documents, advising head office on pricing aspect, receiving delegation from abroad, arranging meeting schedules, accompanying delegation to meeting for sake of convenience (to overcome language problem);
- Creating awareness in India about the products of head office, receiving trade enquiries and passing it to head office (without engaging in negotiation), collecting feedback from clients and passing it to head office;
- Collecting information on economic and industrial policy of Govt and communicating to head office, language interpreters service to head office employees when they visit India, making hospitality and travel arrangements for visiting employees and getting their security clearances;
- Holding of seminars, advertising about the technology used by the head office in providing the services and answering the questions of clients, collecting feedback, preparing reports;
- providing training, conducting refresher course for agents about standards of service and security, accounting procedures, telecommunication systems and configurations, merchandising standards etc.

3.3 Having understood what activities of LO would not create PE, it is now appropriate to look at activities that will create PE and what should an investigating officer should look for in a LO.

3.3.1 It is well understood that communicating information would be preparatory or auxiliary service. So if LO is also communicating information about the price of the product to the client in India that would be preparatory or auxiliary. However, when the LO is doing more than just communicating then there would be a case of PE, as exceptions provided shall not be applicable. In *Jebon Corporation vs. CIT* 2011 -15-HC-Kar-INTL, the High Court held that a LO constituted a PE, when it negotiated sales price with local customers based on the parameters determined by its head office; procured purchase orders for the head office; followed up for payments from the customers; and provided after sales support. Just because goods were directly dispatched to the buyers in India and the buyer directly cleared the imported goods from customs authorities and made payment to head office would not be sufficient to say that activities of LO are preparatory or auxiliary.

3.3.2 Similarly in *Rolls Royce Plc vs. DDIT* (2008) 113 TTJ 446 (Del ITAT) (which was affirmed by Delhi HC in *Rolls Royce Plc vs. DIT* (2011) 339 ITR 147), a LO rendered marketing support service which included soliciting requests from customers for quotation or purchase orders, and undertaking promotional activities which converted quotation requests into orders for the foreign enterprise. The customers in India were

required to route their orders through the local office only. The Tribunal held that the LO is PE of foreign enterprise. This was confirmed by Delhi HC. Thus when activities go beyond just communication of the product description and price to Indian client, the exclusion Clause may not apply. It is very important for the investigating officer to look into the exact nature of activities performed by LO.

3.3.3 One of the very good means of investigation is to look at the salary structure of employees of LO. Whether they are getting fixed salary or there is also a component for variable salary based on number of order secured. This would help in determining facts that LO is doing more than communication. In *Brown & Sharpe Inc vs. ACIT* [2014] 51 taxmann.com 327, it was held by Allahabad HC that the disclosure which were made by the assessee before the AO clearly indicated that during the year, the activities of LO were not confined only to being a channel of communication between the head office in US and prospective buyer in India. The activities of the liaison office included: (i) explaining the products to buyers in India; (ii) furnishing intimation in accordance with the requirements of the buyers; and, (iii) a discussion of commercial issues pertaining to the contract through the technical representative, after which an order was placed by the buyer directly. Apart from this, it is significant that the performance of the personnel in India was judged by the number of direct orders that the assessee received and by the extent of awareness of the assessee that was generated in India. The assessee had an incentive plan under which an employee was allowed to receive up to 25% of its annual remuneration as incentive. Whether or not any incentive was, in fact, paid to an employee during the year in question, is not material. What is relevant is that the nature of the incentive plan would clearly indicate that the purpose of the liaison office in India was not merely to advertise the products of the assessee or to act as a link of communication between the assessee and a prospective buyer but involved activities which traversed the actual marketing of the products of the assessee in India because it was on the basis of the orders generated that an incentive was envisaged for the employees.

3.3.4 Similarly, in a case dealt by the Supreme Court of Finland, a foreign company marketed computer programs developed by its parent company through its office premises in Finland. Two employees worked at such office that prepared and promoted sales of the products. The employees were paid commission in addition to a fixed salary. Further, orders made by the clients were also received by the office in Finland. The binding contracts and other documents were signed at the headquarters abroad. The Supreme Court of Finland held that when the activities of the employees were taken into account, the office in Finland was not considered as a mere advisory or monitoring office and the activities of the office were not considered as of a preparatory or auxiliary character and a permanent establishment was deemed to exist.

3.3.5 We have seen earlier that in case of a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, if the activities of LO are confined to collection of news and views in India for transmission out of India, then it is not taxable under domestic Act. The DTAA also provides exemption for supply of information having preparatory or auxiliary character. However, where the news office is engaged not only in the collection of information but also carries out editorial function such as translation work, writing reports etc., the permanent establishment exclusion may not apply. Thus, the exemption is limited to the news bureaux and not available to editorial offices.

3.3.6 At this stage it is also important to look at another issue. We have seen how LO can create PE if activities are more than just communication or representation. The question that we need to

discuss at this stage is whether this rule would apply to all activities of LO or there is separate rule for purchase function of LO. This is for the reason that there is special exemption for purchase function in the Act and in DTAA. We have earlier seen that if the activities of LO are confined to the purchase of goods in India for the purpose of export, it is not taxable under the domestic Act. Similar exemptions are there in DTAA. The question before us is, the scope of purchase function which is entitled to exemption. There are two different views on this issue. The first view that the exemption include all activities is as per Bangalore ITAT decision in the case of *Nike Inc vs. ACIT* (2010) 125 ITD 35 (revenue appeal to HC dismissed). In this case, LO undertook procurement support activities of branded finished products for its head office such as assistance in collection and dissemination of market intelligence on products and prospective suppliers; opinion on reasonability of prices charged by suppliers; special audit of the supplier; vendor selection; product development; testing of raw material and manufacturing goods; production scheduling; factory training of suppliers; direct supervision of the manufacturing process; quality checks on the exported goods; tracking delivery dates of goods; providing assistance for dispatch of goods etc. Similarly, the ITAT Mumbai in the case of *ADIT vs. M. Fabricant & Sons Limited* (2011) 9 taxmann.com and (2012) 26 taxmann.com 193, held that the activities of the Indian liaising office of a US company involving preliminary inspection, quality check, price negotiations and subsequent purchase of diamonds are integral part of purchase functions and thus, no permanent establishment is created. The Tribunal also observed that all the activities were performed prior to the purchase and thus, is subset of the purchase process. Thus, as per this view for purchase function even if the activities of LO are more than just communication/ representation; no PE can be created.

3.3.7 However, there is second view which is based on the rationale that the LO is practically involved in all the activities connected with the business of the foreign enterprise except actual sale of branded products in overseas markets. Hence, it cannot be called preparatory or auxiliary activity and creates PE. This view was taken by AAR in the case of *Columbia Sportswear Company, In re* (2011) 201 Taxmann 214 (ruling 862 of 2009). AAR observed that the activities undertaken by the Indian liaison office was not merely confined to purchase of goods or merchandise or collection of information and it included function like assistance in vendor selection, quality control, production monitoring, review of costing data, uploading material price in the data system. It undertakes laboratory testing of fabrics/ garments in India in addition to inspecting the quality of the products, interacts with the suppliers in relation to capacity utilization, quality assurance, on-time delivery performance and so on. AAR found it difficult to accept that all the activities above enumerated are activities confined to purchase. It further observed that the activity of the LO are practically an involvement in all the activities connected with the business of the applicant except the actual sale of the products outside the country.

3.3.8 However, the decision of AAR in *Columbia Sportswear Company,* has been reversed by Karnataka HC. High court held that all the activities carried out by LO are necessary to complete the purchase of goods from India and hence, it is not taxable in India. So unless the HC decision is reversed by SC, it appears that when activities are confined to purchase of goods from India then there will be no taxability in India for any activity that is necessary to complete the purchase even though it is more than communication/ representation. However, if some activities performed by LO pertain to post purchase operation, then the situation would be different and it can be examined whether

these activities are merely communication/ representation or something more.

3.3.9 A very important point which needs to be kept in mind that exemption from constituting PE on account of preparatory and auxiliary service is available only when such activities are carried out by the enterprise for itself and not where such activities are performed for other entities or other customers. UN Commentary (para 18 of 2011 commentary) and OECD commentary (para 26 of 2010 commentary) makes it clear that fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of auxiliary or preparatory activities. This is for the reason that the exclusion Clause uses the term 'for the enterprise'.

4. EVEN IF THE ACTIVITIES ARE WITHIN THE PERMISSION GRANTED BY RBI, CAN THEY STILL BE CALLED PREPARATORY OR AUXILIARY?

4.1 Another important issue is what is preparatory or auxiliary? The DTAA would grant exclusion from PE for functions of preparatory or auxiliary character. So even if RBI guidelines are not violated, we need to satisfy that functions performed are of preparatory or auxiliary character. In order to decide what constitute preparatory or auxiliary it is useful to see Klaus Vogel book on Double Taxation Conventions, Third Edition, page no 321 and 322. According to it.

> *"As to whether or not a specific activity is of a preparatory or auxiliary character, each case will have to be examined on its merits; regard being had to the enterprise's overall activity. The question to be asked against this background is whether the activity concerned has a preparatory or auxiliary character in the sense of its being of no or of very little significance in view of the other work performed by the enterprise. Whether it is ordinary and necessary for the enterprise to undertake an activity itself is difficult to clearly determine, especially if the practice in an industry is such that more and more enterprises contribute to the production process so that the involvement of any one firm is smaller. It does not depend on the scope of the means employed. Thus a business representation with six employees but which lacked the authority to conclude contracts is also not a permanent establishment……..*
>
> *It is only where they are exercised for the enterprise itself that such preparatory or auxiliary activities do not constitute a permanent establishment. If they are services rendered for a consideration and for a third party, they will constitute the enterprise's main object, and corresponding facilities may well be permanent establishments. In an individual case, an activity of a specific kind exercised within the framework of an enterprise may be no more than of an auxiliary character, while being the sole business activity of some other enterprise, such as in the case of advertising or scientific research. Where a laboratory, generally performing nothing but preparatory services for the enterprise to which it belongs, or the advertising division of an enterprise, in certain cases also performs services directly for third parties, its activities will to that extent no longer be of an auxiliary character. The laboratory, or the advertising division, as a whole will then be subject to taxation as a permanent establishment……"*

4.2 Thus, in order to decide whether a particular activity is preparatory or auxiliary we need to look at the work performed by the enterprise as a whole and then see the work of

LO. If the work of LO is significant in the context of overall functions of the enterprise then it is not preparatory or auxiliary. Klaus Vogel also talks about an important aspect that works of R&D, advertisement, if done for the enterprise may be preparatory or auxiliary but when done for third party it would not be preparatory or auxiliary. So if the nonresident enterprise is doing the business of manufacturing and sale and LO in India is doing advertisement, one can say that the functions performed are preparatory or auxiliary in nature. However, if the business of nonresident enterprise is do advertising for its customers and the work of advertising done by LO is significant to overall functions of the nonresident enterprise, the exemption of preparatory or auxiliary would not be available.

4.3 To illustrate, where collection of information forms the core business activity of the enterprise, whether done by a representative office or agent it may trigger a permanent establishment. Bloomberg, a US partnership firm engaged in the business of producing databases and informative products had setup a representative office in Russia. The partnership firm was engaged in collection of information which was eventually incorporated in the final informative products. The State Commercial Court of Moscow (*Bloomberg LP vs. Tax Inspectorate*, Case Number A40-94391/ 10-142-134m dated 8th Dec 2010) rejected the argument of Bloomberg that the activity of collection of information was only auxiliary or preparatory in nature and held that collection of information by the representative office was a crucial component of Bloomberg's core business and thus, was not of 'preparatory or auxiliary' in character. Similarly, where the fixed place of business not only gives information but also furnishes plans etc. specially developed for the purposes of the individual customer, the same may not qualify as preparatory or auxiliary character.

4.4 Similarly, in *Pioneer Overseas Corporation vs. ADIT* [2010] 37 SOT 404, (ITAT Delhi), the US Corporation engaged in the business of producing and selling various varieties of agricultural hybrid seeds, setup a branch in India. The Income-tax Appellate Tribunal, Delhi observed that branch office activities of developing and producing hybrid breeder seeds and their use as input for production of parent seeds formed a composite process. The Tribunal thus, held that the activities undertaken by the branch office formed an integral part of the core business activities of the US Company and thus, the exclusion of activity, being auxiliary or preparatory in nature is not available. Further, it may be noted that where the results of the research carried out in the laboratory are not only used by the head office but are also sold to third party, the exception of auxiliary or preparatory will not apply.

5. SUGGESTION FOR INVESTIGATING OFFICERS

5.1 The above discussion clearly demonstrates that proper facts gathering is a must before one can decide whether LO constitutes PE or not? The assessee would always try to show that its activities are only of communication or representation and nothing beyond it. It will also claim that its activities are within the approval granted by RBI. There is no doubt that LO is a fixed place and hence can create fixed place PE. Assessee would try to demonstrate that since activities are preparatory or auxiliary, there is no PE. The arguments of assessee can only be countered by proper fact findings.

5.2 During search/ survey, access to e-mail correspondences of key employees are important to collect evidences in case the assessee is found to be doing more than communication/ representation. The following activities, if evidence for the same is available through e-mails, would demonstrate that activities of LO are not preparatory or auxiliary:-

- LO may be found to be negotiating the price of goods sold with Indian clients based on parameters set by HO. There

are instances where LO is given a range of price within which he can finalize the deal with the Indian client.

- Sometime the LO may not be negotiating but the standard template is taken to the Indian clients and the order is routed through LO.
- LO is involved in finalizing various other terms of the contract like when the delivery should take place, how will delivery take place, the technical aspect of contract etc.
- The orders for goods are routed by Indian clients through LO.
- LO is following up on payments from the customers to whom goods have been sold
- LO is doing after sales support services
- LO is involved in clearance of goods sold by head office in India or in managing logistic of goods within India.
- LO is involved in pre bid survey, in feasibility and technical analysis of the project.

5.3 As discussed earlier, the salary structure of the employees would also be useful in determining whether the role of LO extends beyond communication/ representation. If employees are paid a part of salary linked to actual sale, it is a good evidence to establish that activities are not preparatory and auxiliary and support can be taken from Karnataka HC decision in *Jebon Corporation* discussed above. However, it is advisable that some more facts may also be collected other than mere the salary details. There is always a possibility that in appeal an argument may be taken by the assessee that sale of goods in India is a proxy since it is the job of LO to increase aware of the products in India. Hence, it is necessary that investigating officer should look for e-mails account of these employees to gather proper facts about actual functions done by these employees. Statement of such employees should also be recorded regarding how they engage with clients.

5.4 Every LO in India is required to furnish a statement in respect of its activities during a given Financial Year in Form No.49C. The details of employee benefit expense, a large amount of operating expense and travelling and conveyance expense can also give an idea about possible line of investigation. To illustrate, in case of travelling and conveyance expense, details of these expenses should be put to the employees and they should be asked the reasons for undertaking such travel. Their e-mail and their statement would give evidence of actual purpose of their travel which would be helpful in determining whether the LO is performing preparatory and auxiliary activities.

5.5 It should also be seen during fact finding if the activities are done only for the head office or also for other group entities/ third parties and if activities go beyond head office then clearly it is not a case of preparatory or auxiliary activities.

CHAPTER

4

Investigation of Undisclosed Foreign Assets Cases

1. INTRODUCTION

In recent past, the immensity of the cases of undisclosed foreign assets handled by the Income-tax Department have increased substantially such as LGT Bank cases, HSBC foreign bank account cases, ICIJ cases, Panama papers cases, Paradise papers cases, Bahamans cases, etc. and various other cases involving undisclosed foreign assets unearthed during the search & seizure operations conducted by the Department. In the past few years, the Government of India has also accorded considerable priority to this area by taking various major steps including the following:

- Constitution of the Special Investigation Team (SIT) on Black Money under the chairmanship and vice-chairmanship of two former Judges of Hon'ble Supreme Court in 2014 for supervision & monitoring of undisclosed foreign assets cases.
- Enactment of a separate more stringent new law–Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 to deal with the issue of black money stashed abroad.
- Constitution of the Multi-Agency Group (MAG) under the convenorship of Member(Inv.), CBDT in 2016 and consisting of senior officers of ED, RBI, FIU, etc. to coordinate for expeditious investigation in undisclosed foreign assets cases revealed under Panama & Paradise papers, etc.
- Enhancing global efforts to combat tax evasion/ black money by joining the Multilateral Competent Authority Agreement in respect of Automatic Exchange of Information and having information sharing arrangement with USA under its Foreign Account Tax Compliance Act,
- Renegotiation of DTAAs with other countries to bring the Article on Exchange of Information to International Standards and expanding India's treaty network by

signing new DTAAs and TIEAs with many jurisdictions to facilitate the exchange of information and to bring transparency.

- Amending the Prevention of Money-laundering Act, 2002,
- Enactment of the Benami Transactions (Prohibition) Amendment Act, 2016 to amend the Benami Transactions (Prohibition) Act, 1988,

It is seen from the past-experience that there is need for better appreciation of the *modus operandi* of tax evasion in such cases and capacity of the field formation of the Department also needs to be augmented with a view to expedite and improve the outcome.

2. A BRIEF OVERVIEW OF THE *MODUS OPERANDI* OF TAX EVASION

2.1 The *modus operandi* of tax evasion involved in these cases is generally different from what is noticed in domestic tax evasion cases. The experience shows that the offshore financial system relies on a global industry of bankers, lawyers, accountants, etc. who work together to protect their client's secrets. These secrecy experts use anonymous companies, trusts and other entities to create complex offshore structures that can be used to disguise the origins of black money as well as the identity of actual owner(s). The offshore entities and assets, which include properties, bank accounts, companies, trusts, foundations, etc., are generally owned indirectly through beneficial ownership. The assets/ bank accounts are generally not held directly in the name of the Indian persons and they are found to be beneficial owner/ ultimate beneficial owner/ beneficiary of overseas entities (mostly layered)/ assets/ bank accounts after investigation of different layers of complex offshore structures. Legal or apparent owners of such offshore entities/ assets are generally a façade created to hide the real owners/ beneficiaries.

2.2 In these cases, corporate service providers (such as Mossack Fonseca, Portcullis Trust, etc.) play a significant role in organising offshore affairs of the Indian persons. Such service providers are instrumental in getting their offshore companies, trusts, etc. incorporated in generally no-tax/ low-tax jurisdictions such as British Virgin Islands (BVI), Panama, Bahamas, Cayman Islands, Belize, Mauritius, United Arab Emirates (UAE), Cyprus, Cook Islands, Guernsey, Jersey, Isle of Man, Seychelles, Bermuda, etc. These tax havens don't only attract their global clientele with low or no tax, but one of their main USPs is secrecy. Such tax havens are masters of opacity and as a result of the same there are strict laws in place that forbids any form of disclosure or investigation. It is noticed that the bank accounts and other assets including immovable properties are owned through these entities incorporated in tax heavens in foreign jurisdictions like Switzerland, UK, Singapore, UAE, Cyprus, Hong Kong, Luxembourg, Netherlands, USA, etc. Few instances of direct holding of bank accounts and assets by the Indian persons in various foreign jurisdictions are also noticed. However, a word of caution is needed here to appreciate that all offshore structures do not necessarily involve tax evasion and many of them might have been created for global tax planning/ tax avoidance.

3. FRAMEWORK FOR INVESTIGATION AND OTHER ACTIONS

3.1 Legal Framework

Income-tax Act provides the general legal framework for investigation of cases of Income-tax evasion which includes powers of search & seizure, survey, summons, etc.

3.1.1 Amendments in the Act

In order to facilitate assessment of cases having income in relation to any asset, including financial interest in any entity, located outside India, provisions of Section 149 of the Income-

tax Act, 1961 has been amended and Clause (c) has been inserted to sub-section (1) of Section 149 of the Act, with effect from 01.07.2012, to enable the Assessing Officer to issue notice under Section 148 of the Act up to 16 years from the end of the relevant assessment year in all such cases where income in relation to any asset (including financial interest in any entity) located outside India, chargeable to tax, has escaped assessment.

3.1.2 The Black Money Act

However, recognizing certain limitations of the Income-tax Act, the Government enacted a comprehensive and a more stringent Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 (Black Money Act) with a view to tackle the issue of black money stashed abroad in a more effective manner. The Black Money Act has come into force with effect from 01.07.2015. Assessment Year 2016–17 is the first AY under this new Act. Salient features of this Act are as under:

a. Separate taxation of undisclosed foreign income and assets.

b. More stringent provisions for concealment penalties (equal to three times the amount of tax payable as against variable percentage under the Income-tax Act).

c. More stringent provisions for criminal prosecutions (rigorous imprisonment up-to 10 years with fine for wilful attempt to evade taxes, etc. as against 7 years under the Income-tax Act).

d. The offence of wilful attempt to evade tax, etc. in relation to undisclosed foreign income/ assets under Section 51 and all other offences under The Black Money Act are non-compoundable and the option to approach the Income-tax Settlement Commission (ITSC) is also not available.

e. Most importantly, for the first time, Black Money Act has included the offence of wilful attempt to evade tax etc. in relation to undisclosed foreign income/ assets under Section 51 as a scheduled offence/ predicate offence for the purposes of the Prevention of Money-laundering Act, 2002 (PMLA).

Inclusion of the offence of wilful attempt to evade tax, etc. under Section 51 of The Black Money Act as a scheduled offence under PMLA enables attachment and confiscation of the proceeds of crime of wilful attempt to evade tax, etc. in relation to undisclosed foreign income/ asset i.e. the black money stashed abroad, eventually leading to recovery of such black money stashed abroad. Further, PMLA was amended through the Finance Act, 2015 enabling attachment and confiscation of property equivalent in value held within the country.

The above salient features suggest that–(i) the focus of The Black Money Act is on criminal consequences i.e. prosecutions, (ii) the offence under Section 51 has also been included as a scheduled offence under PMLA, which may lead to separate consequences under PMLA, (iii) the action under BM Act has to be focused and quick with a view to achieve the aforesaid objectives.

3.2 Administrative Framework

With a view to have more expeditious and efficient administrative framework for implementation of The Black Money Act, the CBDT vide Notification No.39 of 2017 dated 16th May 2017 has authorized DsGIT(Inv.)/ Pr.DsIT(Inv.) to assign concurrent jurisdiction of Assessing Officer (AO) to DDIT(Inv.)/ ADIT(Inv.) concerned for exercising the powers and functions of AO under BM Act. Further, in order to operationalize the above scheme of concurrent jurisdiction and to address certain relevant issues, the CBDT has issued *'Guidelines for handling cases under the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015'* vide letter dated 23rd January 2018 in F.No.414/ 134/ 2015-IT(Inv.)(Pt.) which are effective

from 01.02.2018. These guidelines, inter alia, provide clarification with respect to various important issues including stage of assigning concurrent jurisdiction of AO to DDIT/ ADIT, time limit for issuance of notice *u/s* 10(1), stage of sharing information with ED for action under PMLA, references/ requests to relevant foreign jurisdictions, show cause notice & assessment order, prosecutions under the Black Money Act, stage of sending case records to regular AO for further action, etc.

3.3 Importance of Electronic Evidence

It is noticed that information of undisclosed foreign assets is mostly detected in the electronic/ digital devices gathered during the search and seizure operations which include e-mail correspondences, information stored (as draft, etc.) in secret e-mail ids, deleted data recovered through forensic procedure, WhatsApp communications, excel/ word files, SMS exchanged, etc. Hence, it is very important to properly handle the digital devices, e-mail communications, etc. gathered during the searches & surveys conducted by the Department. The CBDT has issued *"Digital Evidence Investigation Manual 2014"* with a view to streamline the handling of digital evidence gathered by the Department. Soft copy of the same is available on the official website of the CBDT (www.irsofficersonline.gov.in) under 'Restricted Communications' in 'Official Communique' Section.

3.4 Conducting Investigations Abroad

The most important aspect of investigation of undisclosed foreign assets cases is the capacity to conduct investigations abroad because most of the requisite information/ evidence lies in foreign jurisdictions. The legal instruments for conducting investigations abroad/ obtaining information from foreign jurisdictions include tax treaties (DTAA/ TIEA/ Convention on Mutual Administrative Assistance in Tax Matters), Mutual Legal Assistance in criminal matters/ Mutual Legal Assistance Treaty (MLAT), Egmont framework of FIUs, etc.

3.4.1 Tax Treaties: Relevant aspects of requests/ references to foreign jurisdictions under tax treaties (through FT&TR Division) are discussed in the Manual on Exchange of Information released by the CBDT in May 2015 which includes the Performa for making the requests, guidelines, etc. Soft copy of the Manual is available on the official website of the CBDT and link is https://www.irsofficersonline.gov.in/Documents/OfficalCommunique/1526201561034.pdf

It is important to note that certain tax treaties of India also contain provisions of 'Tax Examinations Abroad'. For example, India-UK DTAA contain Article 28A in this respect which, inter alia, provide that UK competent authority may allow representatives of the Indian competent authority to visit UK to interview individuals (to record statement of individuals) and examine records, subject to certain conditions.

3.4.2 MLAT: A brief overview on the requests/ references/ assistance under MLAT and Egmont framework has been given in Chapter VI: Assistance from Foreign Countries under other Legal Instruments of the aforesaid Manual on Exchange of Information 2015. The Indian central authority for sending requests under MLAT is Joint Secretary (IS-II), Ministry of Home Affairs (MHA). However, all the requests of the Department under MLAT are to be sent to MHA through Nodal Officer of the CBDT [Director/ DS (Investigation-I), CBDT] only and such requests should not be sent to MHA directly. For further information on requests under MLAT, Nodal Officer of the CBDT may be consulted and official website of the Central Bureau of Investigation may also be seen [link: http://www.cbi.gov.in/interpol/ invletterrogatory.php].

Request for information under Egmont framework should be sent through Nodal Officer of the CBDT [Director/ DS(Investigation-IV),

CBDT] only. However, it may be noted that the information received through this channel is intelligence only, and the same should be travelling accordingly and as per MoU dated 20.09.2013 between CBDT and FIU.

3.4.3 Other Important Aspects: In the context of the information exchanged under the aforesaid legal instruments, the confidentiality and usage obligations of these treaties/ instruments with respect to the information received, which have been discussed in the aforesaid Manual must be strictly followed.

It is seen that India has no tax treaty, MLAT or other legal instruments for obtaining information/ assistance from certain foreign jurisdictions. In the absence of any legal instrument for exchange of information/ seeking assistance, it is difficult to gather the requisite information/ evidence from such foreign jurisdictions. Under these circumstances, the route of Letter Rogatory (LR) with Assurance of Reciprocity may be attempted to obtain the requisite information/ assistance from such foreign jurisdictions. The broad format and procedure for sending LR with Assurance of Reciprocity are the same as that of LR under MLAT.

In addition to the above, other SOPs/ Guidelines/ Instructions/ Circulars issued by the CBDT from time to time on these matters may also be referred to.

4. IMPORTANT ASPECTS TO BE KEPT IN MIND WHILE INVESTIGATING UNDISCLOSED FOREIGN ASSETS CASES

As it could be seen from the nature of these cases, evidence gathering is the main challenge as most of it lies in multiple foreign jurisdictions many of which (particularly tax havens) are generally not very prompt and co-operative. The capacity to undertake prompt investigations abroad through effective use of various legal instruments such as DTAAs, TIEAs, Multi-Lateral Conventions, MLATs, Egmont, etc. is a key aspect. Another key aspect is conducting investigation in these cases in a systematic and sustained manner.

4.1 Appreciation of the Information and Verification from Income-tax Returns (ITRs)

Whenever some information of foreign assets comes to notice, efforts should be made to have clear understanding and appreciation of the information, inter alia, keeping in view the *modus operandi* of tax evasion. This may include proper identification of account holder(s), beneficial owner(s), beneficiaries, authorized signatories, etc. associated with accounts, assets & entities; nature of linkages between account holder(s), beneficial owner(s) and authorized signatories; nature of linkages between various entities & individuals involved in such offshore structure; other persons linked with accounts, entities, etc. This is an important step for keeping the investigation in right direction and focused. Following proper appreciation of the information and *prima facie modus operandi*, the reporting/ disclosure status of such information in ITRs of the person(s) concerned should be verified wherever reporting of such information was legally mandated in Schedule FA of ITR.

4.2 Enquiries

Depending upon the nature of the information and other relevant aspects, a call may be taken regarding the mode of enquiry i.e. discreet or open. If it is decided to conduct open enquiry at this stage, the person(s) involved in the above should be asked specific queries with respect to the above, inter alia, through summons and/ or examination on oath. This should be done very carefully because it may lead to filing of prosecution complaint(s) against assesses for false statement in verification, etc. and other offences

(including those under IPC) if at any subsequent stage it is found that the person(s) had given false statement in verification. Replies furnished by representatives of the person(s) concerned in response to summons issued should not be accepted without a legally valid authority/ power of attorney. Nowadays, public domain (google, social networking websites, etc.) is also good source of information about a person including travelling details, houses & vehicles owned, other assets owned.

Many jurisdictions such as U.K., BVI, etc. have made certain information available on official websites of their respective departments/ agencies which could be obtained/ downloaded there from. In a nutshell, domestic efforts should be exhausted before making references/ requests for information to foreign jurisdictions.

4.3 Requests/ References to Foreign Jurisdictions

Based upon the outcome of the above exercise and information gathered, requests/ references may be required to be made to the respective foreign jurisdictions, inter alia, with a view to obtain the requisite information for further proceedings. While making requests/ references to foreign jurisdictions, relevant aspects should be kept in mind including the following:

- Identification of correct foreign jurisdictions from where useful information could be requested,
- Using appropriate legal instrument (DTAAs, TIEAs, Multilateral Conventions/ Agreements, MLATs, Egmont, etc.) with respect to the identified foreign jurisdictions,
- Timely and correct references to foreign jurisdictions under available legal instruments and following up the same through the Indian competent authorities,
- Brief facts of the case/ background, applicable legal provisions of the Income-tax Act and BM Act, information & other assistance requested etc. should be clearly brought out.
- Only relevant and unambiguous query should be raised. Further, effort should be made to request only factual information and subjective queries should be avoided.
- Taking into consideration the *modus operandi* of tax evasion in these cases, our focus should be on requesting details of beneficial owners/ ultimate beneficial owners, beneficial shareholders, settlors, beneficiaries, etc.
- Foreseeable relevance of the information/ assistance requested with our case/ investigation should be clearly brought out.
- The requirement of dual criminality should be fulfilled in requests/ references under MLATs,
- Relevant provisions of the Indian Evidence Act, particularly Sections 78(6) and 65B, should be quoted/ reproduced in our references/ requests, inter alia, for making the evidence admissible in the Indian courts on its receipt,
- Whenever some clarification is asked by the CBDT or relevant foreign jurisdictions in the context of our references/ requests, the same must be accorded highest priority and provided on the most urgent basis.
- In the above context, the Manual on Exchange of Information 2015 and other guidelines/ instructions/ circulars issued by the CBDT from time to time may also be referred to,
- On receipt of information from foreign jurisdictions, careful analysis of the same should be done and follow up investigations should be undertaken expeditiously which may include further requests to foreign jurisdictions.

The persons concerned should be examined/ interrogated and confronted with the available evidence diligently. All the facts and evidence should be collected, collated and marshalled to culminate in passing of quality assessment orders under the BM Act and filing of criminal prosecution complaints in appropriate cases after carefully analyzing the same with respect to Fulfilment of ingredients of offences. Proper prosecution complaint should be drafted covering all relevant aspects of the case and offence after following the prescribed process. Prosecution complaints should be filed before respective criminal courts without delay and pursued on regular basis.

4.4 Chain of Custody

In this context, important aspects of chain of custody in the context of evidence should always be kept in mind with a view to prove the integrity of evidence.

4.5 Confidentiality and Usage Obligations Under Tax Treaties

The information received from foreign jurisdictions under tax treaties can be disclosed only to the prescribed persons/ authorities and used only for tax purposes as stipulated in the tax treaties. They may also be used in public court proceedings or in judicial decisions. Thus, there is restriction on sharing of such information with other law enforcement agencies (LEAs) such as ED, CBI, etc. Therefore, the Department should not share such information with these agencies without prior express permission of the sharing state i.e. the foreign jurisdiction providing the information. For this purpose, a request may be forwarded to the sharing foreign jurisdiction through FT&TR Division of CBDT in the prescribed performa. However, these agencies can obtain such information from the Court directly once the prosecution complaint enclosing such information is filed by the Department.

5. BRIEF HIGHLIGHTS OF CERTAIN MAJOR FOREIGN ASSETS INVESTIGATIONS CONDUCTED BY THE DEPARTMENT

5.1 HSBC Foreign Bank Account Cases

Information regarding 628 Indian persons holding bank accounts in HSBC bank in Switzerland was obtained from the Government of France in 2011 under the Double Taxation Avoidance Convention (DTAC) between India and France. Swiss authorities, however, did not share any worthwhile information on grounds of treaty limitations and their domestic laws, in response to our requests under DTAA between India and Switzerland. The consent waiver mechanism used in many cases yielded encouraging results in a good number of cases.

Information on 628 persons/ entities was received out of which 569 persons have been traced so far. Undisclosed income of about Rs. 8437 crore (including Rs. 1686 crore in protective assessments) is brought to tax upon completion of assessments in 410 cases. Tax demand of about Rs. 5426 crore has been raised. Concealment penalty of about Rs. 1287 crore has been levied in 161 cases and initiated in another 72 cases. More than 15% of contested demand has been recovered. So far, 199 prosecution complaints in 83 cases have been filed for various offences under the Income-tax Act which include offences under Sections 276C [35 cases], 276CC [4 cases], 276D [20 cases] and 277 [35 cases].

5.2 ICIJ/ Offshore Leaks Cases

The International Consortium of Investigative Journalists (ICIJ), a Washington based organisation; put in public domain [www.icij.org] certain information pertaining to offshore

entities based in no-tax/ low-tax jurisdictions in 2013. It included name and address of Indian persons, name and address of offshore entities, date of formation of related offshore entities, relation of the Indian person with offshore entities, etc. The number of Indian persons in the list was about 700. However, no information relating to financial transactions/ bank accounts was made available.

Investigations were initiated by the Department in these cases which have resulted in 577 Indian persons being traced so far. 465 persons have been found to be 'Resident'. Verification of ITRs in these cases shows that in large number of cases, such offshore entities/ transactions were not disclosed to the Department. During the investigation, 214 persons have admitted their relationship with such offshore entities/ transactions. Searches were conducted in 36 cases. 479 references/ requests to foreign jurisdictions were made in response to which certain information was received in 323 cases. In 63 cases, investigation reports have been sent to the Assessing Officers for further action.

Undisclosed assets/ income of more than Rs.11,000 crore has been detected out of which an amount of about Rs. 573.57 crore has been admitted by certain assessees as their undisclosed income relatable to these offshore transactions which include income declared under 3 months' compliance window of BM Act. Further investigations are in progress. So far, 72 prosecution complaints in 31 cases have been filed for various offences under the Income-tax Act which include offences under Sections 276C [47 cases], 277 [55 cases], 277A [5 cases] of the Income-tax Act and under Sections 181 of IPC [8] and 191 of IPC [12].

5.3 Panama Papers Cases

Certain information, reported to be outcome of investigation by ICIJ, appeared in public domain including the website of ICIJ (www.icij.org) and Indian Express of Delhi edition of 4th April 2016 and subsequent dates without any information on financial transactions. These cases are popularly known as Panama Papers leaks cases.

The investigation into Panama papers leaks cases are being done under supervision of the Multi-Agency Group (MAG) headed by the Member (Inv.), CBDT.

The Panama papers leaks cases contained certain details of 426 persons, *prima facie*, Indian persons or persons of Indian origin. The Department has conducted enquiries in all 426 cases. About 300 references were made to 21 foreign jurisdictions under Tax Treaties. Based upon analysis of the information obtained and investigation conducted so far, 144 cases are found actionable and 282 non-actionable. Out of 144 actionable cases, searches were conducted in 32 cases and surveys in 11 cases. In other cases, the persons were confronted with the evidence. In 5 cases, prosecution complaints have been filed for various offences. In 7 cases, notices under Section 10 of BM Act have been issued. Investigations so far have led to detection of undisclosed foreign assets of about Rs.792 crore. Out of 282 non-actionable cases, 98 who were contacted are non-residents; no *prima facie* irregularity has been found in 73 cases; 111 are not actionable at present due to their whereabouts in India being not known despite best efforts, being citizens of other countries, etc.

5.4 Bahamas Cases

ICIJ reportedly made revelations in public domain in September, 2016 as part of Bahamas papers leaks on its website (www.icij.org) pertaining to certain offshore entities held/ owned by various persons. The information available on the website, however, did not contain any information relating to Indian persons. However, there is need to visit the website of ICIJ on regular basis as they keep on updating the information uploaded on their website in this regard.

Based upon intelligence available from other sources, investigation has been initiated in certain cases apparently linked to Bahamas papers leaks. 16 names have been identified so far out of which 11 are found to be Resident. During their examination, 4 persons have admitted their relationship with such foreign entities. Search action has been conducted in 1 case by Delhi Investigation Directorate. 4 requests/ references have been made so far to relevant foreign jurisdictions. Further investigations are in progress.

5.5 Paradise Papers

The largest ever leak of financial data called the 'Paradise Papers' was leaked to the public on 5th November, 2017. It has about 13.4 million documents relating to offshore investments. It is suggested that the documents originate from the offshore law firm Appleby, the corporate services providers Estera and Asiaciti Trust, and business registries in 19 tax jurisdictions, often referred to as 'tax heavens'. On 17th November, 2017, the International Consortium of Investigative Journalists (ICIJ) published additional data in the Offshore Leaks Database on close to 25,000 entities connected to the Paradise Papers investigation. More than 70 per cent of the new records belong to entities incorporated in Bermuda and the Cayman Islands. Other jurisdictions that also include hundreds of new records are the Isle of Man, Jersey and Mauritius. Most of the online registries from these jurisdictions don't provide ownership or shareholder information.

The leaks which constitute the most detailed revelations ever of such records has nearly 7 million records from Appleby and affiliates, a noted multi-jurisdictional law firm, cover the period from 1950 to 2016 and include e-mails, billion-dollar loan agreements and bank statements involving at least 25,000 entities connected to people in 180 countries. Appleby is a member of the 'Offshore Magic Circle,' an informal clique of the planet's leading offshore law practices. The firm was founded in Bermuda and has offices in Hong Kong, Shanghai, the British Virgin Islands, the Cayman Islands and other offshore centres. As per a report on the Indian Express website, among the 180 countries represented in the data, India ranks 19th in terms of the number of names.

Paradise Papers do unearth tracks of veiled offshore financial activities and unlike in the previous leaks, the latest revelations are more about mega corporates than individual players and how they took advantage of and, in many cases, misused offshore jurisdictions. It is indeed the fifth major leak of financial papers in the past four years and the scale of the information in the Paradise Papers and how it lifts the lid on sophisticated, upper-end offshore dealings is unprecedented.

The papers suggest offshore footprints of some of India's major corporate players as well as of a few high net worth individuals. There are instances of assets of Indian companies being used to guarantee loans raised by offshore companies without disclosing it to Indian regulators. Changing ownership of offshore companies to actually change the ownership of shares held by them in Indian companies without paying taxes in India turns out to be another common feature.

The Finance Ministry has issued a press release saying that investigations in cases of Paradise Papers will be monitored through a reconstituted Multi Agency Group (MAG), headed by the chairman, CBDT (Central Board of Direct Taxes), having representatives from CBDT, ED (Enforcement Directorate), RBI (Reserve Bank of India) and the FIU (Financial Intelligence Unit).

6. AUTOMATIC EXCHANGE OF INFORMATION (AEOI)-COMMON REPORTING STANDARDS (CRS) AND FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

India is now a leading force in global efforts to forge a multi-lateral regime for pro-active sharing of financial information, known as AEOI, aimed

at assisting the global efforts to combat tax evasion.

6.1 CRS

India played a pro-active and prominent role in development and implementation of the new global standards on automatic exchange of information which are known as CRS. India joined a group of 48 countries as 'early adopters' of CRS. We are expected to exchange information automatically as per these standards from 2017. This will further strengthen the framework of international cooperation in the matters involving undisclosed foreign assets/ income.

A declaration has also been signed in November 2016 on automatic exchange of banking information between India and Switzerland.

6.2 FATCA of USA

Information sharing arrangement with USA under its FATCA was entered on 9th July 2015. Automatic exchange of information under FATCA has started from 30th September 2015.

6.3 OECD Pact

Combating offshore tax evasion and enhancing a worldwide cooperation for exchange of information was one of the key objectives of India when the country signed the multilateral pact with the Organisation of Economic Cooperation and Development (OECD) in June 2017.

7. HANDLING OF INFORMATION RECEIVED THROUGH THE ABOVE MECHANISMS

The information received through the above-mentioned mechanisms (CRS and FATCA) is being dealt with in accordance with the procedure laid down under the aforesaid Manual on Exchange of Information 2015 and the CBDT's guidelines in this regard in close coordination with the Directorate of Risk Assessment, inter alia, for risk categorization of these cases.

8. ROAD AHEAD

Action against tax evasion/ black money, particularly black money stashed away abroad is an on-going process. The last few years have seen unprecedented action in this regard, thus bringing to tax substantial quantum of undisclosed assets and income held abroad and also filing of criminal prosecution complaints in considerable number of cases, leading to creation of credible deterrence against such acts. The newly enacted BM Act and the proactive steps taken by the Department towards enhanced exchange of information on tax matters, including on tax crimes, are expected to further boost such efforts in the future. The on-going investigations into ICIJ/ Offshore leaks cases, Panama papers leaks cases and other undisclosed foreign assets/ income cases would lead to assessments and other proceedings (including penalty and criminal prosecutions) under the Black Money Act. Also, as mentioned above, the assessees would not have the option of ITSC and compounding of offences under the Black Money Act which is likely to further enhance the deterrence aspect. The newly envisaged scheme of assigning concurrent jurisdiction of Assessing Officers to DDIT(Inv.)/ ADIT(Inv.) conducting investigations of undisclosed foreign assets/ income cases is likely to facilitate in taking these cases to logical conclusion under the Black Money Act in an expeditious and more effective manner. As discussed above, the offence of willful attempt to evade tax, etc. *u/s* 51 of the Black Money Act has been made a scheduled offence for the purposes of PMLA, the Department is expected to share the relevant information in appropriate cases with ED at the earliest possible stage to enable them to take action under PMLA in this regard.

CHAPTER

5

Black Money Act

1. BACKGROUND

The Undisclosed Foreign Income and Assets (Imposition of Tax) Act, 2015 (hereafter 'BMA, 2015') was introduced through a separate bill in 2015. The object Clause of the BMA, 2015 clearly states that the purpose of the Act is:

> *"To make provisions for undisclosed foreign income and assets, the procedure for dealing with such income and assets and to provide for imposition of tax on any undisclosed foreign income and asset held outside India and for matters connected therewith or incidental thereto."*

2. NEED

Tackling offshore tax evasion and tax avoidance and unearthing of unaccounted money stashed abroad has become a pressing concern for governments all around the world. Realizing the limitations of Income-tax Act, 1961 in effectively dealing with the black money stashed abroad/ undisclosed foreign income and assets, the Government came with a fresh and stringent BMA, 2015 which came into force with effect from 01.07.2015 i.e. relevant to AY 2016–17.

3. VOLUNTARY DISCLOSURE SCHEME

The Central Government had notified the 30th day of September, 2015, as the date on or before which a person could make a declaration in respect of an undisclosed asset located outside India under the compliance provisions of the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 ('Black Money Act'). The last date by which a person could have paid the tax and penalty in respect of the undisclosed foreign assets so declared was the 31st day of December, 2015.

4. SCHEME OF THE ACT

> *"There shall be charged on every assessee for every assessment year*

commencing on or after the 1st day of April, 2016, subject to the provisions of this Act, a tax in respect of his total undisclosed foreign income and asset of the previous year at the rate of thirty per cent of such undisclosed income and asset:

Provided that an undisclosed asset located outside India shall be charged to tax on its value in the previous year in which such asset comes to the notice of the Assessing Officer."

It's an Asset Based Assessment instead of Assessment Year based assessment so on receipt of each piece of relevant information the proceedings could be initiated, after due approvals.

Further, as per Section 4(3), the income included in the total undisclosed foreign income and asset under this Act shall not form part of the total income under the Income-tax Act. The salient definitions under the Act are as under:

- "Assessee"- Resident (Sec. 2(2))
- "Undisclosed foreign income and asset"- (Sec. 2(12))
  - The total amount of *undisclosed income of an assessee from a source located outside India* and
  - The value of an *undisclosed asset located outside India.*
- "Undisclosed asset located outside India"- (Sec. 2(11))
  - An asset (including financial interest in any entity) located outside India, held by the assessee in his name or in respect of which he is a beneficial owner, and he has no explanation about the source of investment in such asset or the explanation given by him is in the opinion of the Assessing Officer unsatisfactory.
- Income from a source located outside India:
  - Has not been disclosed in the return filed *u/s* 139 within due date of revised return (RR)
  - For which *return required* but not furnished within due date of RR
- Exclusions
  - Any addition made *u/s* 29 to 43C or 57 to 59 under ITA
  - TP adjustment made *u/s* 92C under ITA
- Undisclosed foreign asset
  - Value of an undisclosed asset located outside India
- Exclusions
  - Any income which has been assessed prior to AY 16–17 under I.T. Act.
  - Which is assessable or has been assessed to tax under 'BMA' 2015.

5. SALIENT FEATURES

The ADIT(Inv.)/ DDIT(Inv.) concerned with the investigation is to be given concurrent jurisdiction with the jurisdictional Assessing Officer (AO) by the order of the competent authority (DGIT(Inv.)/ Pr. DIT(Inv.)) only to the extent of issues pertaining to undisclosed foreign income/ asset and it does not cover issues under the IT Act, 1961. CBDT Notification dated 16.05.2017, authorizes DGIT(Inv)/ PDIT(Inv) to assign concurrent jurisdiction.

Further, it must be borne in mind that the concurrent jurisdiction is to be assigned to concerned ADIT(Inv.)/ DDIT(Inv.) in only those cases where Investigation Report on undisclosed foreign income/ asset has not been sent by the Investigation Directorate to the regular AO by 01.02.2018 i.e. the date from which the Guidelines of the Board on BMA, 2015 was applicable. However, this will not affect the

assessment of cases by ADIT(Inv.)/ DDIT(Inv.), where concurrent jurisdiction has been assigned to them by DGIT(Inv.)/ Pr. DIT(Inv.) prior to 01.02.2018 in pursuance of CBDT notification dated 16.05.2017 and assessment proceedings under BM Act has been taken up by ADIT(Inv.)/ DDIT(Inv.) and Assessing Officer has been informed in Investigation report sent by the investigation directorate.

The Assessing Officer under BMA, 2015 in the field formations should be the Range Head.

The AO is required to issue notice *u/s* 10(1) of the BMA, 2015 only on receipt of "information" and not 'intelligence'. The information could be unearthed during any search/ survey/ other investigation or received under a legal instrument such as a tax treaty or received from other law enforcement agencies (LEAs) and the information has *prima facie* linkage with the Indian person under investigation. Intelligence could be a basis for initiating enquiries under the relevant provisions of the Income-tax Act or the BMA, 2015.

For the purposes of Section 10 of the BMA, 2015 date of assigning concurrent jurisdiction of AO to ADIT(Inv.)/ DDIT(Inv.) would be the date of receipt of information by AO or the date of coming of the information to AO's notice.

Assessment order is to be passed within 2 years from the end of the financial year in which notice *u/s* 10(1) was issued by the AO.

6. RESOURCES AND AREAS OF INVESTIGATION

6.1 On receipt of any intelligence, efforts should be made to gather information, which is actionable as per BMA, 2015. The usual modes of intelligence would include FIU, informant, TEPs, VIP reference, ICIJ, public domain data etc which needs to be investigated through search/ survey/ open enquiry, exchange of information requests from relevant jurisdictions and coordination from other law enforcement agencies. These resources are enlisted below:

6.1.1 Tax Treaties

- Double Taxation Avoidance Agreements (DTAAs),
- Tax Information Exchange Agreements (TIEAs),
- Multilateral Convention on Mutual Administrative Assistance in Tax Matters (Multilateral Convention) and
- SAARC Limited Multilateral Agreement (SAARC Agreement) are the legal instruments which provide a legal obligation on a reciprocal basis for providing various forms of administrative assistance, including Exchange of Information, Assistance in Collection of Taxes, Tax Examination Abroad, Joint Audit, Service of Documents etc.

6.1.2 MLAT

Information and other forms of assistance can also be requested through Mutual Legal Assistance Treaties (MLATs) and Letters Rogatory (LRs) through Ministry of Home Affairs, particularly with countries/ jurisdictions with which there is no tax treaty. Information/ evidence obtained through MLATs can also supplement the information received under tax treaties when a criminal complaint is made for tax evasion on the basis of information received under tax treaties.

6.1.3 EGMONT Requests

Information can also be obtained through Egmont Group of Financial Intelligence Units (FIUs), which is an informal network of FIUs established with a view to have international cooperation including information exchange in the fight against money laundering and financing of terrorism, which may be further be

supplemented by making further requests under tax treaties/ MLATs.

For the purpose of information from Egmont Group, the Nodal Officer in CBDT is Deputy Secretary (Investigation-IV), CBDT. Requests in this regard should be sent by the Pr. DIT concerned to the Nodal Officer in CBDT who, after examining the request, will forward it to FIU-IND. No request should be sent directly to the FIU-IND.

6.1.4 Information through INTERPOL

There are two kinds of assistance/ services that can be availed through CBI, International Police Cooperation Unit (National Central Bureau + International Police Cooperation Cell) in criminal matters *viz.* (i) Formal & (ii) Informal. Issuance of LR/ MLAT pertains to "Formal" kind of assistance and information/ evidence gathered through this channel can be used as evidence in criminal proceedings. However, there is also an informal channel available through INTERPOL Network or NCB to NCB channel which is better known as police to police cooperation channel. Collection of information through informal channels such as INTERPOL is also useful during the investigation.

6.1.5 Publicly Available Information for Different Tax Jurisdictions

a. Guernsey [https://www.greg.gg/webCompSearch.aspx]

b. Cayman Island [www.ciregistry.gov.ky]

c. Isle of Man [http://portal.gov.im/pvi/CompanySearch.aspx]

d. Jersey [https://www.jerseyfsc.org/registry/documentsearch/]

e. Liechtenstein [http://www.oera.li/hrweb/ger/firmensuche_afj.htm]

f. Hong Kong [http://www.icris.cr.gov.hk/csci/]

g. Singapore [https://www.acra.gov.sg/home/]

h. USA[https://www.sec.gov/edgar/searchedgar/companysearch.html]

i. Cyprus [http://www.mcit.gov.cy/mcit/drcor/drcor.nsf/index_en/index_en?OpenDocument#]

j. U.A.E. [http://www.dfsa.ae/PublicReqister/Default.aspx]

k. Companies Register of Member States of European Commission [https://ejustice.europa.eu/ content_business_registers_in_member_states-106-en.do]

l. Compilation of various online Companies Registries/ Government Websites, by 'Open Knowledge Foundation' (OKFN) [index.okfn.org/dataset/companies/]

m. Amadeus provides a database of comparable financial information for public and private companies across Europe which may be seen at https://amadeus.bvdinfo.com

n. A detailed list of companies' registers for various countries is also complied at http://en.wikipedia.org/wiki/List_of_company_registers

o. Financial statements, financial ratio and other business statistics is provided free of charge at http://www.bizstats.com/

p. International white and yellow pages can be accessed at www.wayp.com

6.1.6 Form 3CEB

The Form 3CEB detailing the international transactions and specified domestic transactions entered by the entity under investigation could be a valuable resource to locate and identify foreign subsidiaries and associated enterprises of the entity and in case the financial/beneficial interest is not disclosed in Schedule Foreign Asset (Schedule FA), relevant requests under DTAA/TIEA/ MLAT etc can be made to investigate the same.

7. INCOME-TAX OVERSEAS UNITS

The Income-tax Overseas Units are located in respective embassies and also working in coordination with the assigned tax jurisdictions for better and effective tax management and coordination. Their services may also be employed to expedite certain requests from relevant foreign tax jurisdictions.

7.1 Once in possession of the information, risk profiling of the assessee should be done. Where there is a possibility of assessee fleeing the country, as has been seen lately, a suitable Look Out Notice with the Bureau of Immigration should be opened so that the assessee cannot flee the country without detection. Since it's a restriction on individual's freedom, considered legal opinion and due approvals should be taken.

8. COMPUTATION OF VALUE OF UNDISCLOSED FOREIGN ASSET

Value of the undisclosed foreign assets should be computed as per Rule 3 of BMA, 2015:

9. FILING OF PROSECUTION COMPLAINT

i. The provisions related to Prosecutions are as follows:

- For failure to furnish return with reference to foreign income and asset - R.I. for 6 months–7 years + fine (S.49)
- For failure to report/ furnish inaccurate report with reference to foreign asset in the return of income filed- R.I. for 6 months–7 years + fine (S.50)
- For willful attempt to evade tax- R.I. 3 years to 10 years + fine (S.51)
- For making false statement in verification- R.I. for 6 months–7 years + fine (S.52)
- For abetment- R.I. for 6 months–7 years + fine (S.53)

ii. Provisions from ITA not incorporated in BMA, 2015:

- S. 279(2)- compounding
- S. 279A- non-cognizable offences (Part II of 1st Schedule Cr.PC)

iii. It is pertinent to note that punishment for wilful attempt to evade tax has been made a scheduled offence under Prevention of Money Laundering Act (PMLA). As per the guidelines issued regarding BMA, 2015, the AO should intimate the ED within 7 days of filing prosecution complaint *u/s* 51 of BMA, 2015 for necessary action under PMLA at their end.

iv. It must be noted that completion of assessment, penalty or appeal is not a pre-requisite for filing Prosecution complaint *u/s* 51(1) of the BMA, 2015. Therefore, if *prima facie* satisfaction is arrived based on the information in the possession of the AO, a prosecution complaint should invariably be filed, following the due process laid out in this regard. As per CBDT guideline dated 23.01.2018, it is envisaged in the scheme of concurrent jurisdiction that the entire process of filing prosecution under Section 51 will be much faster than the existing process with regard to assessment in such case. Considering this scheme, it is preferable to process the case for filing complaint under Section 51(1) of the BMA 2015 after completion of due inquiries which culminate in passing of assessment order under Section 10 of B M Act. The AO should submit proposal for prosecution under within 30 days of passing of order under BMA 2015 and should file prosecution within 15 days of receipt of sanction from Pr DIT/ Pr CIT.

v. In appropriate cases prosecution complaint can be filed prior to finalisation

of assessment under Section 10 of BMA 2015 as well since it would be of immense help in using the provisions of Mutual Legal Assistance Treaty (MLAT) etc. apart from the usual Exchange of Information (EoI) requests. MLAT requests should be made expeditiously wherever required.

vi. After filing prosecution complaint under Section 51 of BMA 2015, a Letter of Request (LoR) coupled with a Restraint Order restraining transfer of funds from the relevant account/ asset, as per the provisions of sec 166A r.w.s. 105C, D & E of CrPC and relevant provisions of Mutual Legal Assistance Treaty (MLAT) should be immediately sent through CBDT to MHA for onward transmission to the relevant foreign jurisdiction in appropriate cases. In case there is no MLAT, Assurance of Reciprocity can be obtained from the MHA in this regard and LoR can be sent.

10. SUGGESTIONS

1. Like ED and CBI, there should be a dedicated court for Income-tax Act and BMA so that the actions could be immediately initiated and valuable time is not lost in arguing on merits before a Court not specialised in tax matters.
2. BMA, 2015 could be amended to specifically carry powers of sending LoRs under the Act itself, like PMLA, for expeditious restraint/ confiscation of assets abroad to safeguard the interest of revenue.

CHAPTER

6

Exchange of Information: Investigation from Foreign Jurisdictions

1. INTRODUCTION

1.1 Tackling offshore tax evasion and tax avoidance and unearthing of unaccounted money stashed abroad have become a pressing concern for governments all around the world. The information and/ or evidence of such tax avoidance/ evasion and the underlying criminal activity is often located outside the territorial jurisdiction and thus this menace can be addressed only through bilateral and multilateral cooperation amongst tax and other authorities. The Government of India has played an important role in international forums in developing international consensus for such cooperation as per globally accepted norms and continuous monitoring of their adoption by every jurisdiction including offshore financial centres.

1.2 Despite a global concern and a consensus that offshore tax evasion needs to be tackled through a coordinated action, the information from a foreign country is unlikely to be received on the basis of just letters or a plea regarding their moral obligation to prevent tax evasion and criminal activities. There has to be a legal basis which provides a legal obligation on the requested State to part with the information as otherwise it might be challenged in their own Courts. Further, in many offshore jurisdictions, a substantial part of their economic activity depends on providing financial services to foreign companies and individuals and thus parting with the information may be against their public policy or public opinion of their citizens unless there is a legal basis which obliges them to provide assistance.

1.3 This assistance which was earlier restricted mainly in criminal cases is now considerably expanded, as explained by the Hon'ble Finance Minister in a speech in the Lok Sabha replying on the debate on "Black Money" on 19.11.2014. He had stated that initially, the international norms were to provide assistance to other countries only on satisfaction of the norms of "dual criminality", i.e., in cases of drug trafficking, corruption, terrorist financing etc. which are criminal activities in both countries. However, at present the cooperation has extended to cases of tax evasion and avoidance and countries are

obliged to exchange information requested as per provisions of tax treaties/ agreements. The third stage of cooperation would be automatic exchange of financial account information without countries having to make requests for the same, thereby enabling the receiving country to verify whether such accounts indicate tax evaded money and to take necessary action.

1.4 During the pendency of a matter before a Criminal Court, on request of the investigating authorities, the Court may make a request to a foreign Court to examine a person in their jurisdiction or to require any person in that jurisdiction to produce any document. This formal communication for assistance by Courts is known as Letter Rogatory and is recognised in Sections 166A and 166B of the Code of Criminal Procedure, 1973, as also in laws in most of the countries. The Letter Rogatory does provide a legal basis for exchange of information and evidence between countries but is limited in its scope because the prerequisite is pendency of matter in a criminal court and the recognition of the offence as a criminal one in other country. Wide range of mutual legal assistance in criminal matters can also be provided through Mutual Legal Assistance Treaties (MLATs). However, in the case of MLATs also, the assistance is normally possible only on the satisfaction of the norms of "dual criminality", i.e., in cases of drug trafficking, corruption, terrorist financing etc. which are criminal activities in both countries. The cooperation through MLATs is, therefore, generally not possible in case of tax evasion and avoidance unless the offences fall under the category of economic crimes.

1.5 The tax treaties, in contrast, provide a legal basis for wide range of administrative assistance including exchange of information on request, assistance in collection of taxes, automatic exchange of information, tax examination abroad etc. Through a process of global consensus, agreed international standards for implementation of the legal framework for administrative assistance have also been laid down and the countries/ jurisdictions are under a legal obligation to provide the information if a request is made for information. As per these standards and the legal framework, there is no pre-requisite for pendency of criminal proceedings and the only condition which needs to be satisfied before making the request is that the information requested is "foreseeably relevant" for administration or enforcement of domestic laws of the requesting State. The requested State may seek clarifications, however, if the requesting State clarifies that the information is indeed required for the purposes of its domestic laws, the assistance cannot be denied.

1.6 It is now possible to seek information from most countries and offshore jurisdictions and in a large majority of cases they are providing useful information since it is their legal obligation to do so. In fact, the framework of information exchange on request is grossly under travelling by the tax authorities as they are not aware of its potential or are skeptical that information will actually be received from abroad.

2. TAX TREATIES FOR ADMINISTRATIVE ASSISTANCE

Tax treaties are the legal instruments obliging the contracting states to provide wide range of administrative assistance. These tax treaties include the following:

- Double Taxation Avoidance Agreements (DTAAs): The primary purpose of the DTAAs is the allocation of taxing rights between the treaty partners and the avoidance of double taxation. However, DTAAs also have as an objective of prevention of fiscal evasion and contain provisions for providing administrative assistance including exchange of information for assistance in implementation of the DTAA and in administration or enforcement of domestic tax laws of the Contracting States.

- Tax Information Exchange Agreements (TIEAs): The TIEAs have provisions only for exchange of information and are entered into with those countries/ jurisdictions (such as offshore financial centres) where it may not be feasible to enter into a comprehensive DTAA.
- Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MAC) is a multilateral instrument which provides for a wide range of administrative assistance including exchange of information, assistance in collection of taxes, tax examination abroad, etc. It is in force in India since 1st June, 2012.
- SAARC Limited Multilateral Agreement (SAARC Agreement) is a multilateral agreement amongst SAARC countries and is in force since 1st April, 2011 and has provisions for a wide range of administrative assistance

With many countries/ jurisdictions, there is more than one tax treaty. Administrative assistance can be requested under the provisions of the appropriate treaty depending on the purpose of assistance. For instance, with a country "X", assistance in collection of taxes may not be possible under DTAA but may be available under the MAC making it an appropriate choice of tax treaty for such requests. The list of India's tax treaties is available on the Department's website.

3. KEY CONCEPTS ON EXCHANGE OF INFORMATION ON REQUEST BASIS

3.1 Legal Basis for Exchange of Information on Request

3.1.1 The legal basis for Exchange of Information on Request is contained in Article 26(1) of the DTAAs, Article 1 of the TIEAs, Article 4(1) of the MAC and corresponding provisions under the SAARC Agreement. Article 26(1) of the OECD and UN Model Tax Convention is reproduced below

"*The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for*

- carrying out the provisions of this Convention
- or to the administration or enforcement of the domestic laws

concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation there under is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2."

Article 1 of the OECD Model TIEA of 2002 states the following:

"*The competent authorities of the Contracting Parties shall provide assistance through exchange of information that is foreseeably relevant to the administration and enforcement of the domestic laws of the Contracting Parties concerning taxes covered by this Agreement. Such information shall include information that is foreseeably relevant to the determination, assessment and collection of such taxes, the recovery and enforcement of tax claims, or the investigation or prosecution of tax matters*."

Article 4(1) of the MAC is reproduced below

"*The Parties shall exchange any information, in particular as provided in this Section, that is foreseeably relevant for the administration or enforcement of their domestic laws concerning the taxes covered by this Convention*."

Article 5 of the SAARC Agreement is reproduced below

"*The Competent Authorities of the Member States shall exchange such information, including documents and public documents or certified copies thereof, as is necessary for carrying out the provisions of this Agreement or of the domestic laws of the Member States concerning taxes covered by this agreement insofar as the taxation thereunder is not contrary to the Agreement.*

Any information received by a Member State shall be treated as secret in the same manner as information obtained under the domestic laws of that Member State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes covered by the agreement. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions."

3.1.2 The legal obligations under the above treaties obliges the Contracting Parties or States, as the case maybe, to mandatorily provide the information which is foreseeably relevant for carrying out the provisions of the treaty (minor information Clause) or for administration or enforcement of the domestic laws of the requesting State/ Party (major information Clause).

3.1.3 The minor information Clause is available in DTAAs and the SAARC Agreement, as it distributes the taxing rights amongst the Contracting States and for correct allocation of such taxing rights information is required to be exchanged between the source and residence States. For example, for the application of Article 12 relating to Royalty, the Source State may request the Residence State whether the recipient is a resident and whether he is the beneficial owner of the royalties in order to exempt them from withholding. Conversely for application of Article 12, the Residence State may also request the Source State the amount of royalties transmitted to its residents. Other examples of minor information Clause include exchange of information with a view to proper allocation of taxable profits between associated enterprises in different countries or the adjustments of the profits shown in the accounts of a permanent establishment in one State and in the accounts of the head office in the other State or information exchange for the purposes of Mutual Agreement Procedure.

3.1.4 In the TIEAs and MAC, however, there is no minor information Clause as under these treaties, there are no provisions for allocation of taxing rights. However, in these treaties, as also in the DTAAs, the "major information Clause" exists which provides a legal obligation to the Contracting Parties to provide information which is foresee ably relevant for administration or enforcement of the domestic laws of the requesting State/Party. Under the provisions of the treaties, as explained below, the requesting State/ Party being in the full knowledge of its taxation laws and its investigations and examinations determines the foreseeable relevance of the information requested. Accordingly, the major information Clause is a very strong provision and except for fishing expeditions and certain other limitations provided under the treaties, this provision facilitate wide range of cooperation amongst Contracting States/ Parties for effective administration and enforcement of domestic laws with a view to tackle/ prevent tax evasion and avoidance.

3.2 COMPETENT AUTHORITY

3.2.1 Under the tax treaties such as DTAAs, TIEAs and MAC, the information is exchanged by the Competent Authorities nominated by the Contracting States/ Parties, which are normally the tax authorities in the Ministry of Finance. The tax authorities are designated as competent authorities as the information can be efficiently and quickly exchanged between them fulfilling the aim of fighting tax evasion and avoidance rather than routing the same through the normal diplomatic channel which may be time consuming.

3.2.2 The term "Competent Authority" is defined in the tax treaties as an authority who has been authorized to be so by the Contracting States/ Parties. In India, Joint Secretary (FT&TR-I) is the Competent Authority for countries/ jurisdictions located in Europe and North America (including Caribbean) while Joint Secretary (FT&TR-II) is the Competent Authority in the case of tax treaties with the rest of the world.

3.2.3 The request for information is initiated by the tax authorities in the requesting jurisdiction carrying on investigation or assessment who makes a reference to its competent authority making a recommendation for seeking information under the tax treaties from a treaty partner. The competent authority of the requesting jurisdiction examines the request and verifies whether it satisfies the conditions prescribed in the treaties including demonstration of the foreseeable relevance of the information requested. In appropriate cases, the competent authority may seek clarifications from the officers who had made the request. After being satisfied, a formal request is made by the competent authority of the requesting jurisdiction to the competent authority of the requested jurisdiction. The competent authority of the requested jurisdiction also verifies the request at his end and on being satisfied that the request conforms to the provisions contained in the treaties initiates necessary steps to collect the information. This may be done by the office of competent authority itself by using its own information gathering powers or it can request its investigation or audit wing to provide the information after carrying out necessary investigation or audit.

3.2.4 Since the information is exchanged between the competent authorities, the tax authorities carrying out investigation or assessment are not authorized to seek information directly from their counterpart and the request for information must be routed through the office of competent authorities. Moreover, since the powers of the tax authorities' end at their borders they normally cannot seek information from taxpayers or third parties located outside their jurisdiction. Thus, in the process of collecting and exchanging information, the competent authority plays a very important role.

3.3 PERSONS COVERED

3.3.1 Article 26 (1) of the OECD and UN Model Tax Convention specifically provides that the exchange of information is not restricted by Article 1 of the DTAA. Article 1 of the DTAA provides that the Convention shall apply to persons who are residents of one or both of the Contracting States. Thus, under the DTAAs, the information about residents of a third country may also be exchanged.

3.3.2 In the OECD Model TIEA of 2002, in the Commentary to Article 2 it is provided that the requested Party's obligation to provide information is not restricted by the residence or the nationality of the person to whom the information relates. Similarly, in the MAC, in Article 1(3) it has been specifically mentioned that a Party shall provide administrative assistance whether the person concerned is a resident or national of a Party or of any other State.

3.3.3 The rationale that under the tax treaties exchange of information is not limited to information relating to the affairs of residents of the contracting parties is that there may be situations where a requesting jurisdiction could have an interest in receiving information about a third country resident who is not subject to tax in either of the contracting parties, for instance when this information is relevant to the taxation of a third party who is a taxpayer or resident of the requesting party. This is of course subject to the limitation that the requested jurisdiction cannot provide information on third country residents that is neither held by their authorities nor is in the possession or control of persons within their territorial jurisdiction.

3.4 TAXES COVERED

3.4.1 Article 26 (1) of the OECD Model Tax Convention specifically provides that the exchange of information is not restricted by Article 2 of the DTAA. Article 2 of the DTAA lists the taxes to which the Convention applies. Thus, under the DTAAs, the information about taxes which are not covered by the DTAAs such as VAT or Excise duties can also be exchanged.

3.4.2 Further, Article 26(1) applies to *"taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, in so far as the taxation there under is not contrary to the Convention."* Thus, taxes levied by the State Governments e.g. sales tax or by local authorities e.g. municipal taxes are also covered under the scope of exchange of information and a requesting State can demand the information regarding these taxes and the requested State is obliged to provide the same.

3.4.3 In the OECD Model TIEA of 2002, in Article 3, the taxes which are subject to the agreement are required to be listed by the contracting Parties and the exchange of information is restricted to only those taxes. The Commentary to Article 3 specifies that the bilateral agreements will cover, at a minimum, the same four categories of direct taxes (i.e., taxes on income or profits, taxes on capital, taxes on net wealth, and estate, inheritance or gift taxes) unless both parties agree to waive one or more of them. It is further stated that a Contracting Party may decide to omit any or all of the four categories of direct taxes from its list of taxes to be covered but it would nevertheless be obligated to respond to requests for information with respect to the taxes listed by the other Contracting Party. In addition, the Contracting Parties may also agree to cover taxes other than the four categories of direct taxes such as indirect taxes.

3.4.4 The MAC is intended to have very wide scope and covers all forms of taxes levied by central or state governments or by the local bodies, including social security contributions, with the sole exception of those customs duties and all other import-export duties and taxes which are covered by the International Convention on Mutual Administrative Assistance for the prevention, investigation and repression of customs offences, prepared under the auspices of the World Customs Organisation. The taxes covered by the Convention have been grouped into two categories. The first category includes taxes levied at central government level on income or profits, on capital gains or on net wealth, for which the Contracting Parties have to necessarily provide assistance. The second category includes all other taxes covered in the Convention in respect of which the Parties may provide reservations for not providing assistance.

3.4.5 The first category of taxes as listed in Article 2(1)(a) of the MAC are (i) taxes on income or profits, (ii) taxes on capital gains which are imposed separately from the tax on income or profits, and (iii) taxes on net wealth, imposed on behalf of a Party.

3.4.6 The second category of taxes as listed in Article 2(1)(b) of the MAC are:

i. Taxes on income, profits, capital gains or net wealth which are imposed on behalf of political subdivisions or local authorities of a Party,
ii. Compulsory social security contributions payable to general government or to social security institutions established under public law, and
iii. Taxes in other categories, except customs duties, imposed on behalf of a Party, namely:
    a. estate, inheritance or gift taxes,
    b. taxes on immovable property,
    c. general consumption taxes, such as value added or sales taxes,
    d. specific taxes on goods and services such as excise taxes,
    e. taxes on the use or ownership of motor vehicles,
    f. taxes on the use or ownership of movable property other than motor vehicles,
    g. any other taxes;

iv. Taxes in categories referred to in sub-paragraph iii. above which are imposed on behalf of political subdivisions or local authorities of a Party.

The Parties to the Convention may provide reservations for not providing assistance in respect of the second category of taxes.

3.5 STANDARD OF FORESEEABLE RELEVANCE

3.5.1 The standard of "foreseeable relevance" is the key to the Exchange of Information on Request and once the requesting jurisdiction satisfies the requirements of foreseeable relevance, the requested jurisdiction will be required to mandatorily provide the information under the legal obligation of the tax treaties which the jurisdiction has entered into as a sovereign.

3.5.2 The standard of "foreseeable relevance" is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to engage in "fishing expeditions" or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer.

3.5.3 Whether particular information requested is foreseeably relevant or not could be a subject of disagreement between the requesting State and the requested State. This conflict has been resolved by the latest amendments to the Commentaries wherein it has been stated that the competent authorities should consult in situations in which the content of the request, the circumstances that led to the request, or the foreseeable relevance of requested information are not clear to the requested State. However, once the requesting State has provided an explanation as to the foreseeable relevance of the requested information, the requested State may not decline a request or withhold requested information because it believes that the information lacks relevance to the underlying investigation or examination.

3.5.4 This principle has been explained in Para 11 of the document containing the proposal to update Article 26 (Exchange of information) of the United Nations Model Double Taxation Convention between Developed and Developing Countries and its Commentary by stating that given the complexity of taxation laws and taxpayer investigations and examinations, it is the requesting country, with full knowledge of its taxation laws and its investigation or examination, that is in the best position to determine the foreseeable relevance of the requested information. Thus, the requesting State has been given the primacy in determining whether request for any information is foresee ably relevant or not further emphasizing the mandatory nature of the information exchange making it a valuable instrument for tackling tax evasion and avoidance.

3.5.5 In the context of information exchange upon request, the standard of foreseeable relevance requires that at the time a request is made there is a reasonable possibility that the requested information will be relevant, whether the information, once provided, actually proves to be relevant is immaterial. A request may therefore not be declined in cases where a definite assessment of the pertinence of the information to an ongoing investigation can only be made following the receipt of the information.

3.5.6 Thus, the standards of foreseeable relevance contemplates a priori assessment of the requested information by the requesting State and its relevance to the applying the provisions of the treaty or the enforcement or administration of the domestic laws. If the information after being received has not or would not have contributed to a different result e.g. a higher tax assessment, for this reason only the information could not be treated as not being foresee ably relevant.

3.5.7 As an example, the requested State cannot deny a copy of the trust deed of the discretionary trust in which the beneficiaries are the residents of the requesting State on the grounds that no distribution has taken place and as per the taxation laws of the requesting State, the income is taxable in the beneficiaries of a discretionary trust only on distribution. It is possible that on examining the trust deed and other relevant documents, the tax authorities of requesting State would determine that the settlor and/ or protector were residents of the requesting State and/ or the structure of the trust has been created to hide the assets acquired through tax evaded income in the requesting State. This will particularly would be the case where the trustees of the "discretionary" trust are professionally managed companies managing thousands of trusts in a discretionary manner.

3.5.8 As an another example, if the requesting State requests for copies of the bank accounts and narration of major entries in the said bank account of a taxpayer who is non-resident in the requesting State, the requested State cannot deny the information only because the income of non-resident may not be taxable in the requesting State. In this case, it is possible that the requesting State, which taxes the income sourced in that State in the case of non-residents, may after examining the entries in the bank account would indeed determine that the source of such income is in the requesting State.

3.5.9 The OECD Model TIEA of 2002 provides a checklist of information which the competent authority of the requested Party is required to provide when making a request for information to demonstrate the foreseeable relevance of the information to the request. In the OECD and UN Model Tax Convention as also in the Multilateral Convention, there is no specific checklist. However, the commentaries imply that almost the same information as mentioned in the checklist need to be provided under those instruments also. Further, in many DTAAs, such as between India and Switzerland, in the additional Protocols, the checklist of information which is required to be provided by the requesting State has been specified, which are again almost identical to the checklists under OECD Model TIEA. The checklist provided in the OECD Model TIEA is now part of international standards and thus even in those legal instruments where it has not been specifically mentioned, the requesting jurisdiction must provide the same to demonstrate the foreseeable relevance of the requested information.

3.5.10 The checklists of information, as specified in the OECD Model TIEA, which the requesting jurisdiction must provide are the following

a. *The identity of the person under examination or investigation;*

b. *A statement of the information sought including its nature and the form in which the applicant Party wishes to receive the information from the requested Party;*

c. *The tax purpose for which the information is sought;*

d. *Grounds for believing that the information requested is held in the requested Party or is in the possession or control of a person within the jurisdiction of the requested Party;*

e. *To the extent known, the name and address of any person believed to be in possession of the requested information;*

f. *A statement that the request is in conformity with the law and administrative practices of the applicant Party, that if the requested information was within the jurisdiction of the applicant Party then the competent authority of the applicant Party would be able to obtain the information under the laws of the applicant Party or in the normal course of administrative practice and that it is in conformity with this Agreement;*

g. *A statement that the applicant Party has pursued all means available in its own territory to obtain the information, except those that would give rise to disproportionate difficulties.*

With regard to identity of person under investigation or examination in (a) above, if a requesting Party is asking for account information but the identity of the accountholder(s) is unknown, it would be enough if the account number or similar identifying information is supplied.

3.5.11 While making request for information under tax treaties the tax authorities/ competent authorities of the requesting country/ jurisdiction should satisfy itself that the conditions of "foreseeable relevance" has been satisfied and the checklist of information, as mentioned above, has been provided. This would ensure that the information from foreign jurisdictions is received expeditiously and delay in providing clarifications is avoided.

3.6 INFORMATION EXCHANGE WITHOUT DOMESTIC TAX REQUIREMENTS

3.6.1 In Article 26 of the OECD Model Convention, a new paragraph 4 was added in 2005 to deal explicitly with the obligation to exchange information in situations where the requested information is not needed by the requested State for domestic tax purposes. This new paragraph is reproduced below

"4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information."

3.6.2 Prior to the addition of above paragraph, although the obligation was not expressly stated, but was followed in practice by many Contracting States who often use the special examining or investigative powers provided by their laws for purposes of levying their domestic taxes even though they do not themselves need the information for these purposes. Many countries, however, did not follow this practice and accordingly it was decided that there is a need for specific legal provision for the same and accordingly paragraph 4 was introduced in the Model Tax Convention.

3.6.3 Para 19.7 of the Commentary to Article 26 of the OECD Model Tax Convention states that According to paragraph 4, Contracting States must use their information gathering measures, even though invoked solely to provide information to the other Contracting State and irrespective of whether the information could still be gathered or used for domestic tax purposes in the requested Contracting State. Thus, for instance, any restrictions on the ability of a requested Contracting State to obtain information from a person for domestic tax purposes at the time of a request (for example, because of the expiration of a statute of limitations under the requested State's domestic law or the prior completion of an audit) must not restrict its ability to use its information gathering measures for information exchange purposes. The term "information gathering measures" means laws and administrative or judicial procedures that enable a Contracting State to obtain and provide the requested information. Paragraph 4 does not oblige a requested Contracting State to provide information in circumstances where it has attempted to obtain the requested information but finds that the information no longer exists following the expiration of a domestic record retention period. However, where the requested information is still available notwithstanding

the expiration of such retention period, the requested State cannot decline to exchange the information available. Contracting States should ensure that reliable accounting records are kept for five years or more.

3.6.4 Since the new paragraph has been introduced in the OECD Model Tax Convention only in 2005, in many of the older DTAAs, paragraph 4 is still not there. However, a large number of jurisdictions in their assessment by the 'Global Forum' have confirmed that even if paragraph 4 in not present in their DTAAs, they will provide the information even if they have no domestic interest in the same. It may also be noted that Article 5(2) of the OECD Model TIEA of 2002 and Article 21(3) of the Multilateral Convention provides that the requested Party is obligated to provide information requested notwithstanding the fact that it may not need such information for its own tax purposes.

3.7 EXCHANGE OF BANKING INFORMATION

3.7.1 In Article 26 of the OECD Model Convention, a new paragraph 5 was added in 2005 to ensure that the limitations of paragraph 3 cannot be used to prevent the exchange of information held by banks, other financial institutions, nominees, agents and fiduciaries as well as ownership information. The new paragraph is reproduced below:

"In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person."

However, addition of the new paragraph 5 should not be interpreted so as to suggest that the previous version of the Article did not authorise the exchange of such information and a large majority of jurisdictions, including India, have been exchanging such information under the previous version of the Article and the addition of paragraph 5 merely reflects current practice.

3.7.2 Para 19.11 of the Commentary to Article 26 of the OECD Model Tax Convention states that paragraph 5 stipulates that a Contracting State shall not decline to supply information to a treaty partner solely because the information is held by a bank or other financial institution. Thus, a requested Contracting State cannot decline to supply information on grounds of bank secrecy. The access to information held by banks or other financial institutions may be by direct means or indirectly through a judicial or administrative process. However, the procedure for indirect access should not be so burdensome and time-consuming as to act as an impediment to access to bank information.

3.7.3 Para 19.12 of the Commentary to Article 26 of the OECD Model Tax Convention states that paragraph 5 also provides that a Contracting State shall not decline to supply information solely because the information is held by persons acting in an agency or fiduciary capacity. For instance, if a Contracting State had a law under which all information held by a fiduciary was treated as a "professional secret" merely because it was held by a fiduciary, such State could not use such law as a basis for declining to provide the information to the other Contracting State. A person is generally said to act in a "fiduciary capacity" when the business which the person transacts, or the money or property which the person handles, is not its own or for its own benefit, but for the benefit of another person as to whom the fiduciary stands in a relation implying and necessitating confidence and trust on the one part and good faith on the other part, such as a trustee. The term "agency" is very broad and includes all forms of corporate service providers (e.g. company formation agents, trust companies, registered agents, lawyers).

3.7.4 Para 19.13 of the Commentary to Article 26 of the OECD Model Tax Convention states that paragraph 5 provides that a Contracting State shall not decline to supply information solely because it relates to an ownership interest in a person, including companies and partnerships, foundations or similar organisational structures. Information requests cannot be declined merely because domestic laws or practices may treat ownership information as a trade or other secret.

3.7.5 It may be noted that Article 5(4)(a) of the OECD Model TIEA of 2002provides that the competent authorities should have the authority to obtain and provide upon request, information held by banks, other financial institutions and any person acting in an agency or fiduciary capacity including nominees and trustees. The access to information held by banks or other financial institutions may be by direct means or indirectly through a judicial or administrative process, however, the procedure for indirect access should not be so burdensome and time-consuming as to act as an impediment to access to bank information. The bank information requested would include account, financial, and transactional information as well as information on the identity or legal structure of account holders and parties to financial transactions.

3.7.6 Further, Article 5(4)(b) of the OECD Model TIEA of 2002 provides that the competent authorities should have the authority to obtain and provide upon request information regarding the ownership of companies, partnerships, trusts, foundations, "Anstalten" and other persons, including, within the constraints of Article 2, ownership information on all such persons in an ownership chain; in the case of trusts, information on settlors, trustees and beneficiaries; and in the case of foundations, information on founders, members of the foundation council and beneficiaries. Where the legal owner acts on behalf of any other person as a nominee or under a similar arrangement, for example in case of a nominee shareholding arrangement where the legal title-holder that also appears as the shareholder of record acts as an agent for another person, the Contracting Parties should have the authority to obtain and provide information about that other person who may be the beneficial owner in addition to information about the legal owner. In the case of trusts or foundations or Anstalts, the competent authorities should be able to obtain and provide information on the identity of the settlor and the beneficiaries and persons who are in a position to direct how assets of the trust or foundation are to be dealt with.

3.7.7 It may also be noted that Article 21(4) of the Multilateral Convention provides that the requested State is not permitted to decline the supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

3.8 EXCHANGE OF PAST PERIOD INFORMATION

3.8.1 Para 10.3 of the Commentary on Article 26 of the OECD Model Tax Convention states that nothing in the Convention prevents the application of the provisions of the Article to the exchange of information that existed prior to the entry into force of the Convention, as long as the assistance with respect to this information is provided after the Convention has entered into force and the provisions of the Article have become effective. Thus, the general rule is that once the tax treaty is in force, information may be requested for a period prior to the entry into force of the treaty, in both civil and criminal tax matters. In cases where the earlier treaty is restrictive, e.g. no provision for exchange of banking information, and the treaty is revised through a Protocol, the Contracting States are obliged to exchange information in a non-

restrictive manner even if it relates to the period prior to coming into force of the Protocol.

3.8.2 Para 10.3 of the Commentary on Article 26 of the OECD Model Tax Convention adds that Contracting States may find it useful, however, to clarify the extent to which the provisions of the Article are applicable to such information, in particular when the provisions of that convention will have effect with respect to taxes arising or levied from a certain time. Accordingly, in many DTAAs, the Contracting States have specified the dates from which the provisions of exchange of information would be applicable. These exceptions are normally agreed between Contracting States on account of legal and constitutional restrictions in providing past information in one or both States.

3.8.3 For example, the DTAA between India and Switzerland was amended with effect from 7th October, 2011 enabling exchange of information which is relevant for administration or enforcement of domestic laws, including banking information. As per Article 14(3) of the Amending Protocol, Switzerland is obliged to provide *"information that relates to any fiscal year beginning on or after the first day of January of the year next following the date of signature of the amending Protocol (30th August, 2010)"*, i.e., information that relates to fiscal years 2011–12 onwards. However, if it can be demonstrated that the information created in Switzerland prior to 1st April, 2011, e.g. KYC details would be foresee ably relevant for period after 1st April, 2011, a request for the same can be made. Similarly, the amended DTAA between India and Singapore allows exchange of information for administration or enforcement of domestic laws, including banking information, from 1st April, 2008 onwards.

3.8.4 In the Model TIEA of 2002, a distinction has been made between civil and criminal tax matters. Article15 of the Model TIEA provides that the agreement shall enter into force on 1st January, 2004, with respect to exchange of information in criminal tax matters and on 1st January, 2006, with respect to other matters. The two dates on which the agreement will come into force, however, may be negotiated by the Parties concerned. The Commentary to the OECD Model TIEA, however, clarifies that these rules do not preclude an applicant Party from requesting information that precedes the effective date of the Agreement provided it relates to a taxable period or chargeable event following the effective date. A requested Party, however, is not in violation of this Agreement if it is unable to obtain information predating the effective date of the Agreement on the grounds that the information was not required to be maintained at the time and is not available at the time of the request.

3.8.5 In the Indian TIEAs, the following models have been followed:

a. In case of some TIEAs, e.g., with Liberia, it has been provided that TIEA will have effect as on date which implies that after coming into force of the TIEA, information in both civil and criminal tax matter can be exchanged for past periods also.

b. In the case of some of the TIEAs (Bermuda, Isle of Man etc.) it has been provided that the TIEA will have effect with respect to "criminal tax matters" as "on that day" and for "civil tax matters" for taxable periods beginning on or after the date on which the TIEA comes into effect. This means that in criminal tax matters, the information relating to period prior to coming into force of the TIEA can be requested but not in civil tax matters.

c In the case of TIEA with Bahamas, the information available with the jurisdiction, which relates to the period prior to coming into force of the TIEA (1st March, 2011), cannot be shared.

d The TIEA with Liechtenstein allows for requests for information with regard to tax years beginning on or after 1st April, 2013. The TIEA, however, provides for exchange of documents or information created in or derived from a date preceding 1st April, 2013 that are foresee ably relevant to a request relating to tax years beginning on or after 1st April, 2013, for example:

- If assistance is requested with respect to a taxpayer's bank transactions occurring after March 31, 2013, and documents such as, but not limited to, a signature card for the account in question were executed prior to March 31, 2013, the requested jurisdiction would provide the documents;
- Where a request involves a trust or a foundation and documents such as the deed of settlement or the foundation statutes and/ or bylaws, as the case may be, were executed prior to April 1, 2013, the requested jurisdiction would provide the documents.

3.8.6 In the case of MAC, Article 28(6) provides that the provisions of the Convention shall have effect for administrative assistance related to taxable periods beginning on or after 1 January of the year following the one in which the Convention entered into force in respect of a Party or where there is no taxable period, for administrative assistance related to charges to tax arising on or after 1 January of the year following the one in which the Convention entered into force in respect of a Party. However, Article 28(7) provides that for tax matters involving intentional conduct which is liable to prosecution under the criminal laws of the applicant Party, the provisions of the Convention shall have effect from the date of entry into force in respect of a Party in relation to earlier taxable periods or charges to tax. Thus, for civil tax matters, the Convention has effect only for future tax periods while for criminal tax matters it has effect as soon as it enters into force in relation to earlier tax periods or charges of tax.

3.8.7 Article 30(1)(f) of the MAC, however, provides that parties to the Convention may give a reservation not to provide administrative assistance in case of criminal tax matters which are related to taxable periods beginning on or after 1 January of the third year preceding the one in which the Convention entered into force in respect of a Party, or where there is no taxable period, for administrative assistance related to charges to tax arising on or after 1 January of the third year preceding the one in which the Convention entered into force in respect of a Party. Thus, in criminal tax matters, the requested State may give reservations for not providing assistance for a period which is beyond three years.

3.8.8 It is pertinent to note that "criminal tax matters" has been defined in Article 4(1)(o) of the OECD Model TIEA as all tax matters involving intentional conduct, which is liable to prosecution under the criminal laws of the requesting Party. Since the principles of "dual criminality" has been abolished, it is immaterial whether tax evasion is a criminal offence in the requested Party and the conditions of being a criminal tax matter is satisfied if the offence is liable for prosecution under the laws of the requesting jurisdiction e.g. attempt to evade tax under Section 276 of the Indian Income-tax Act, 1961. In this case, a priori assessment of the requested information which when received may result in a criminal liability needs to be made and it is not necessary that the request can be made only after launch of criminal prosecution.

3.8.9 The Commentary to Article 4(1)(o) of the OECD Model TIEA lists the typical categories of conduct that constitute tax crimes which include the willful failure to file a tax return within the prescribed time period; willful omission or

concealment of sums subject to tax; making false or incomplete statements to the tax or other authorities of facts which obstruct the collection of tax; deliberate omissions of entries in books and records; deliberate inclusion of false or incorrect entries in books and records; interposition for the purposes of causing all or part of the wealth of another person to escape tax; or consenting or acquiescing to an offence. Tax crimes, like other crimes, are punished through fines, incarceration or both.

4. EXEMPTION FROM PRIOR NOTIFICATION

3.9.1 Article 1 of the OECD Model TIEA of 2002 provides that the rights and safeguards secured to persons by the laws or administrative practice of the requested Party remain applicable to the extent that they do not unduly prevent or delay effective exchange of information. Similarly, Article 21(1) of the MAC provides that nothing in the Convention shall affect the rights and safeguards secured to persons by the laws or administrative practice of the requested State.

3.9.2 There is no corresponding provision in Article 26 of the OECD Model Tax Convention but it is implicit in the Convention that the rights and safeguards of persons under national laws and administrative practices are not reduced in any way by the DTAA. However, the requested State's domestic laws and administrative practices providing for such rights and safeguards should not be applied in a manner that undermines the object and purpose of the Convention, i.e., effective exchange of information. This has been explained in Para 14.1 of the Commentary to Article 26 of the OECD Model Tax Convention and Para 180 of Explanatory Report to the MAC in the following words.

"Some countries' laws include procedures for notifying the person who provided the information and/ or the taxpayer that is subject to the enquiry prior to the supply of information. Such notification procedures may be an important aspect of the rights provided under domestic law. They can help prevent mistakes (e.g. in cases of mistaken identity) and facilitate exchange (by allowing taxpayers who are notified to co-operate voluntarily with the tax authorities in the requesting State). Notification procedures should not, however, be applied in a manner that, in the particular circumstances of the request, would frustrate the efforts of the requesting State. In other words, they should not prevent or unduly delay effective exchange of information. For instance, notification procedures should permit exceptions from prior notification, e.g. in cases in which the information request is of a very urgent nature or the notification is likely to undermine the chance of success of the investigation conducted by the requesting State. A Contracting State that under its domestic law is required to notify the person who provided the information and/ or the taxpayer that an exchange of information is proposed should inform its treaty partners in writing that it has this requirement and what the consequences are for its obligations in relation to mutual assistance. Such information should be provided to the other Contracting State when a convention is concluded and thereafter whenever the relevant rules are modified."

3.9.3 Thus, under the laws of certain countries/ jurisdictions, the taxpayer or the holder of the information has certain rights including a right to be informed or notified that a request concerning him for information under a tax treaty has been made and these rights and safeguards are not abrogated by the provisions of the information exchange. However, to ensure that these rights and safeguards do not unduly prevent effective exchange of information, the requesting country in certain exceptional cases can make a request that the taxpayer/ holder of information may not be so notified. In cases where a request to

refrain from notifying the taxpayer(s) concerned is made, the reasons for the same must be clearly explained by the requesting jurisdiction. Such reasons could be that the information is of a very urgent nature and the process of prior notification to the taxpayer will delay supply of information or the prior notification is likely to undermine the success of the investigation being conducted.

3.9.4 A request to refrain from notifying the taxpayer should not be made in a routine manner and such request should be made only if it is essential and can be justified on the basis of documentary evidence. The reason that the taxpayer concerned is likely to file an appeal against the supply of information may not be a valid reason for making such a request.

3.10 LIMITATION ON EXCHANGE OF INFORMATION ON REQUEST

3.8.1 The tax treaties including DTAAs, TIEAs and MAC allows information exchange to the widest possible extent which is necessary for tackling and prevention of the international tax evasion and avoidance. Notwithstanding this basic principle, the treaties also had certain important limitations, some of which are provided in the treaty itself while others follow from the Commentaries and on practical implementations. Some of these limitations are discussed below

a. **Standard of Foreseeable Relevance and Prevention of Fishing Expedition:** The first important limitation under the mechanism of the exchange of information is that the requesting jurisdiction needs to demonstrate the foreseeable relevance of the information requested. Thus, the Contracting States are not at liberty to engage in "fishing expeditions", i.e., speculative requests for information that have no apparent nexus to an open inquiry or investigation, or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer. The prevention of fishing expedition, therefore, provides an important boundary beyond which the information cannot be exchanged.

b. **Principles of Subsidiarity:** The second important limitation to the exchange of information is contained in the principles of subsidiarity which states that the requested State is not obliged to provide information unless the requesting State has pursued all reasonable measures available under its laws or administrative practices to obtain information except where recourse to such measures would give rise to disproportionate difficulties. Thus, if a contract has been entered between a resident of requesting and requested jurisdiction and before asking the copy of the contract from its own resident, a request is made to the other jurisdiction, the other jurisdiction may refuse to provide assistance. Similarly, if the information requested is copy of audited accounts of a company in the requested State which has made investment in a company resident in the requesting State, without first asking from the resident company whether it can provide the said accounts, the requested State may refuse to provide the information.

c. **Variance with Law or Administrative Practice:** The requested State is not obliged to carry out measures at variance with its own laws, nor, since the obligation to provide assistance is further qualified, is the requested State obliged to use powers provided for in its domestic laws but which it does not in practice normally use. This rule is important in safeguarding the rights of taxpayers since it prevents the requesting State from making use indirectly, because

it has sought assistance, of greater powers than it possesses under its own law. By virtue of this principle, the requested State is at liberty, though not obliged, to refuse to grant assistance.

d. Principles of Reciprocity: Reciprocity in relation to exchange of information means that a contracting party, when collecting information for the other contracting party, is obliged only to obtain and provide such information that the requesting party could itself obtain under its own laws in similar circumstances. The underlying idea of the concept of reciprocity is that a contracting party should not be able to take advantage of the information system of the other contracting party if it is wider than its own system. Thus, the requested jurisdiction may refuse to provide information where the requesting party is precluded by law from obtaining or providing information or where the requesting party's administrative practices (e.g., failure to provide sufficient administrative resources) result in a lack of reciprocity.

e Public Policy/ Ordre Public: The Contracting States are not obliged to exchange information which concerns the vital interests of the State itself and do not have to supply information the disclosure of which would be contrary to public policy. Para 19.5 of the Commentary to Article 26 of the OECD Model Convention, however, states that this limitation should only become relevant in extreme cases. For instance, such a case could arise if a tax investigation in the requesting State were motivated by political, racial, or religious persecution. The limitation may also be invoked where the information constitutes a state secret, for instance sensitive information held by secret services the disclosure of which would be contrary to the vital interests of the requested State. Para 19.5, therefore, concludes that the issue of public policy (ordre public) rarely arise in the context of information exchange between treaty partners.

f. Trade, Business and Other Secrets: The tax treaties do not put an obligation to the Contracting States to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process. However, the secrets mentioned should not be taken in too wide a sense and before invoking this provision, a Contracting State should carefully weigh if the interests of the taxpayer really justify its application, as too wide an interpretation would make the exchange of information ineffective in many cases.

g. Legal and Professional Privilege: A requested State may decline to disclose information relating to confidential communications between attorneys, solicitors or other admitted legal representatives in their role as such and their clients to the extent that the communications are protected from disclosure under domestic law. However, the scope of protection afforded to such confidential communications should be narrowly defined. Such protection does not attach to documents or records delivered to an attorney, solicitor or other admitted legal representative in an attempt to protect such documents or records from disclosure required by law. Also, information on the identity of a person such as a director or beneficial owner of a company is typically not protected as a confidential communication. Whilst the scope of protection afforded to confidential communications might differ among States, it should not be overly broad so as to hamper effective exchange of information. Communications between

attorneys, solicitors or other admitted legal representatives and their clients are only confidential if, and to the extent that, such representatives act in their capacity as attorneys, solicitors or other admitted legal representatives and not in a different capacity, such as nominee shareholders, trustees, settlors, company directors or under a power of attorney to represent a company in its business affairs. Communication is "confidential" if the client can reasonably have expected the communication to be kept secret. For instance, communications made in the presence of third parties that are neither staff nor otherwise agents of the attorney are not confidential communications. Similarly, communications made to the attorney by the client with the instruction to share them with such third parties are not confidential communications. The communications must be between a client and an attorney, solicitor or other admitted legal representative. Thus, the attorney-client privilege applies only if the attorney, solicitor or other legal representative is admitted to practice law. Communications with persons of legal training but not admitted to practice law are not protected under the attorney-client privilege rules.

h. **Privilege against Self-incrimination:** Most countries recognise under their domestic laws that information cannot be obtained from a person to the extent that such person can claim the privilege against self-incrimination. A requested State may, therefore, decline to provide information if the requesting State would have been precluded by its own self-incrimination rules from obtaining the information under similar circumstances. In practice, however, the privilege against self-incrimination should have little, if any, application in connection with most information requests. The privilege against self-incrimination is personal and cannot be claimed by an individual who himself is not at risk of criminal prosecution. The overwhelming majority of information requests seek to obtain information from third parties such as banks, intermediaries or the other party to a contract and not from the individual under investigation. Furthermore, the privilege against self-incrimination generally does not attach to persons other than natural persons.

i. **Taxation is Contrary to Generally Accepted Principles:** Under Article 21(2)(e) of the Multilateral Convention, a requested State may refuse to provide assistance "if and insofar as it considers the taxation in the requesting State to be contrary to generally accepted taxation principles". This might be the case, for instance, where the requested State considers that taxation in the requesting State is confiscatory, or where it considers that the taxpayer's punishment for the tax offence would be excessive. Article 21(2)(e) of the Multilateral Convention further provides that the request may also be refused in cases where the requested State considers taxation in the requesting State to be "contrary to the provisions of a convention for the avoidance of double taxation". Such phrase refers to taxation contrary to such convention rules as rates of withholding, the definition of permanent establishment and the determination of their taxable profits and so on. The phrase is not intended to refer to all cases of double taxation. Since income-tax conventions do not eliminate all cases of double taxation, assistance should be provided even though it may result in double taxation not contrary to a convention.

j. **Non-discrimination:** Article 21(2)(f) of the Multilateral Convention and Article

7(6) of the OECD Model TIEA of 2002, is designed to ensure that the Convention does not result in discrimination between nationals of the requested State and nationals of the requesting State who are in the same circumstances. In the exceptional circumstances in which this issue may arise, this provision allows the requested State to decline a request where the information requested by the requesting State would be used to administer or enforce tax laws of the requesting State, or any requirements connected therewith, which discriminate against nationals of the requested State. This is intended to ensure that the Convention does not result in discrimination between nationals of the requested State and identically placed nationals of the requesting State. Nationals are not identically placed where a requesting State national is a resident of that State while a requested State national is not. Thus, this provision does not apply to cases where tax rules differ only on the basis of residence. The person's nationality as such should not lay the taxpayer open to any inequality of treatment. This restriction should apply both to procedural matters (differences between the safeguards or remedies available to the taxpayer, for instance) and to substantive matters, such as the rate of tax applicable.

4. CONFIDENTIALITY

4.1 Overview

4.1.1 The legal obligation of the requested Contracting State to exchange information in Article 26(1) of the OECD Model Tax Convention is complemented by the legal obligation of the requesting Contracting State to treat the information received as secret and use it only for the purposes specified in the Convention as per Article 26(2) of the OECD Model Tax Convention which is reproduced below:

"Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorises such use."

4.1.2 The confidentiality requirement in OECD Model TIEA of 2002 is contained in Article 8 which is reproduced below:

"Any information received by a Contracting Party under this Agreement shall be treated as confidential and may be disclosed only to persons or authorities (including courts and administrative bodies) in the jurisdiction of the Contracting Party concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Agreement. Such persons or authorities shall use such information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. The information may not be disclosed to any other person or entity or authority or any other jurisdiction without the express written consent of the competent authority of the requested Party."

4.1.3 The MAC has even more comprehensive requirements for maintaining the confidentiality of information exchanged in Article 22 relating to secrecy which is reproduced below:

1. "Any information obtained by a Party under this Convention shall be treated as secret and protected in the same manner as information obtained under the domestic law of that Party and, to the extent needed to ensure the necessary level of protection of personal data, in accordance with the safeguards which may be specified by the supplying Party as required under its domestic law.
2. Such information shall in any case be disclosed only to persons or authorities (including courts and administrative or supervisory bodies) concerned with the assessment, collection or recovery of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes of that Party, or the oversight of the above. Only the persons or authorities mentioned above may use the information and then only for such purposes. They may, notwithstanding the provisions of paragraph 1, disclose it in public court proceedings or in judicial decisions relating to such taxes.
3. If a Party has made a reservation provided for in sub-paragraph a. of paragraph 1 of Article 30, any other Party obtaining information from that Party shall not use it for the purpose of a tax in a category subject to the reservation. Similarly, the Party making such a reservation shall not use information obtained under this Convention for the purpose of a tax in a category subject to the reservation.
4. Notwithstanding the provisions of paragraphs 1, 2 and 3, information received by a Party may be used for other purposes when such information may be used for such other purposes under the laws of the supplying Party and the competent authority of that Party authorises such use. Information provided by a Party to another Party may be transmitted by the latter to a third Party, subject to prior authorisation by the competent authority of the first-mentioned Party."

4.2. RATIONALE OF CONFIDENTIALITY PROVISIONS

4.2.1 The rationale for the confidentiality provisions in the tax treaties is that the confidentiality of taxpayer information has always been a fundamental cornerstone of tax systems and the tax administration is obliged to keep the information submitted by the taxpayers, including their sensitive financial and personal information, confidential and is required to take steps to ensure that they are not disclosed inappropriately, either intentionally or by accident. Accordingly, the citizens and Government of a country/ jurisdiction will agree to exchange information with another country only if the information exchanged is kept confidential, used only for the specified purposes and disclosed only in accordance with the agreement on the basis of which it is exchanged.

4.2.2 Further, in many countries, Governments have given commitments to their citizens through Parliament/ Senate that information will not be provided under the tax treaty if the recipient country has not complied with its obligations under the agreement to protect the confidentiality of information and using the information solely for collecting and enforcing taxes covered by the agreement and in many other countries, in taxpayer charters Governments have recognised that the taxpayers have a right to expect that their information will remain confidential. Both taxpayers and tax administrations have, therefore, a legal right to expect that information exchanged under exchange of information agreements remains confidential. This requires that exchange of information partners have adequate safeguards to protect the confidentiality of the information that is shared and assurances that the information provided will only be used for the purposes permitted under the exchange of information instrument.

4.2.3 The legal requirement of maintaining the confidentiality of the information exchanged and using it only for the purposes specified in the treaties is a consequence of these principles.

4.3. IN ACCORDANCE WITH DOMESTIC LAWS OF THE STATE RECEIVING THE INFORMATION

4.3.1 Article 26 (2) of the OECD Model Tax Convention and Article 22(1) of the MAC provides that the any information received under the provisions of the treaty shall be treated as secret in the same manner as information obtained under the domestic laws of the receiving State/ Party. In most countries/ jurisdictions, the tax authorities are legally required to maintain confidentiality of information provided by the taxpayers and the third parties and any violation is sanctioned both administratively and legally. The tax treaties provide that information received under the said treaties will be accorded the same level of protection and the applicable sanctions.

4.3.2 For example in India, the tax authorities are required to keep the taxpayer information received by them confidential under Section 138 of the Income-tax Act, and these provisions would be applicable for the information received under tax treaties also. Section 138 of the Income-tax Act, 1961 read with notifications issued under that Section, provides that, subject to certain exceptions, no public servant shall furnish any information contained in any statement made, return furnished or accounts or documents produced under the provisions of the Act, or in any evidence given, affidavit or depositions made in the course of any assessment proceedings under the Act. Section 280 of the Act, provides that if a public servant furnishes any information or produces any document in contravention of the above, he shall be punishable with imprisonment which may extend to six months and shall also be liable for fine. The provisions of Sections 138 and 280 would also apply in case of information received under the tax treaties including the competent authority letters and the letters requesting the information. Thus, any unauthorized disclosure by a public servant may attract action under Section 280 in addition to administrative sanctions.

4.3.3 The domestic laws for maintaining the confidentiality of taxpayer information normally have certain exceptions, for instance, permitting the tax authorities to disclose the information to other law enforcement agencies or to share it with Financial Intelligence Units. The International Standards on maintenance of confidentiality requires that the domestic laws should have the provision to ensure that these exceptions do not apply in case of information received under the tax treaties if the same is not permitted under the treaty under which the information has been received.

4.3.4 This is ensured by the countries concerned in a number of ways. In some countries, domestic legislation specifically provides that all treaty obligations would be respected. In other countries, the obligations under tax treaties are implemented in such a way that in the event of an inconsistency between a treaty and domestic law, the treaty overrides the domestic law. Regardless of the approach adopted, countries must ensure that the confidentiality obligations are respected when information is received under a tax treaty or other exchange of information mechanism.

4.3.5 Under the Indian jurisprudence, the provisions of international agreements take precedence over domestic or municipal laws. The Hon'ble Supreme Court of India in the case of Azadi Bachao Andolan reported in (2004) 10 SCC 1, has held that provisions of agreements entered into under Sections 90 and 90A of the Income-tax Act, 1961would operate even if inconsistent with the provisions of domestic law. Accordingly, even if the domestic laws such as Section 138 allow sharing of taxpayer information in certain circumstances, such sharing of information received under tax treaties is not possible if the same is not allowed under the provisions of the tax treaties.

4.4 LIMITATION OF DISCLOSURE UNDER TAX TREATIES

4.4.1 The tax treaties, in addition to specifying that the information may be treated as secret/ confidential as per the domestic laws of the receiving State/ Party, also specifies the purposes for which the information may be used and thus limits its further disclosure.

4.4.2 The treaties provide that the information received may be disclosed to persons or authorities (including courts and administrative bodies) involved in the

- Assessment;
- Collection;
- Enforcement;
- Prosecution; and
- Determination of appeals

in relation to taxes with respect to which the information has been exchanged under the treaty. The above referred persons or authorities can use the information only for tax purposes and may disclose the information during their proceedings if such proceedings are open to public, or in their judicial verdicts.

4.4.3 Once information is used in public court proceedings or in court decisions and thus rendered public, it is clear that from that moment such information can be quoted from the court files or decisions for other purposes even as possible evidence. Notwithstanding the above, the persons and authorities referred above are not allowed to provide on request additional information received. Thus, only that information which has been submitted during public court proceedings or are mentioned in the judicial verdicts are public and not the entire information received under the provisions of the tax treaties. Accordingly, the information which does not lead to a public court proceeding such as overseas bank account information which is fully explained by the taxpayer concerned during the assessment proceedings must not be made public.

4.4.4 The references to "public court proceedings" and to "judicial decisions"' in this paragraph extend to include proceedings and decisions which, while not formally being "judicial", are of a similar character. An example would be an administrative tribunal reaching decisions on tax matters that may be binding or may be appealed to a court or a further tribunal. In the Indian context since the proceedings before the Income-tax Appellate Tribunal are public in nature, the information received under the tax treaties may be disclosed during such public court proceedings. The tax authorities, including the Assessing Officer and the Commissioner (Appeals), in contrast do not conduct public proceedings which can be attended by members of the public and thus the information received under the tax treaties cannot be disclosed during such proceedings.

4.4.5 Under the DTAAs and the MAC, the information can also be disclosed to oversight bodies. Such oversight bodies include authorities that supervise tax administration and enforcement authorities as part of the general administration of the Government of a Contracting State. However, the Contracting States may depart from this principle in their bilateral negotiations and agree to exclude the disclosure of information to such supervisory bodies. It is also pertinent to note that in the OECD Model TIEA of 2002, there is no provision for disclosure of information received to the oversight bodies.

4.4.6 Further, the information received under the tax treaties, whether taxpayer-specific or not, should not be disclosed under the domestic information disclosure laws such as freedom of information or other legislation that allows greater access to governmental documents. In the Indian context, the information received from foreign Government is exempt under Section 8(1)(a) and 8(1)(f) of the Right to Information Act, 2005, and thus the information cannot be disclosed under the said Act. It may also be noted that the Supreme Court in

the case of *Girish Ramchanda Deshpande vs. Central Information Commissioner & Ors.*, SLP (Civil) No. 27734 of 2012, has held that the details disclosed by a person in his Income-tax returns are "personal information" which stand exempted under Clause (j) of Section 8(1) of the Right to Information Act, 2005, unless it involves a larger public interest.

4.4.7 The MAC has an added layer of confidentiality of information exchanged whereas it is provided in Article 22(1) that any information obtained by a Party under the provisions of the Convention shall be protected to the extent needed to ensure the necessary level of protection of personal data, in accordance with the safeguards which may be specified by the supplying Party as required under its domestic law. The Commentary to Article 22(1) of the Multilateral Convention makes it clear that the Party receiving the information shall treat them in compliance not only with its own domestic law, but also with safeguards that may be required to ensure data protection under the domestic law of the supplying Party and such safeguards, as specified by the Supplying Party, may for example relate to individual access, independent oversight or redress.

4.4.8 This additional layer of confidentiality in MAC, which is not there in DTAAs and TIEAs, is significant since the automatic exchange of financial account information as per Common Reporting Standards and Country-by-Country report will take place on the legal platform of MAC and the Party supplying the information on an automatic basis can insist that the safeguards provided in its data protection laws may be respected by the Party receiving the information.

4.5. DISCLOSURE FOR OTHER PURPOSES

4.5.1 The tax treaties including DTAAs, TIEAs and MAC permit the use of information received for non-tax purposes on satisfaction of certain conditions. Para 12.3 of the Commentary on Article 26 of the OECD Model Tax Convention mentions that the following two conditions should be satisfied before the information is used for non-tax purposes:

a. the information may be used for other purposes under the laws of both States and

b. the competent authority of the supplying State authorises such use.

4.5.2 The above provision allows the sharing of tax information by the tax authorities of the receiving State with other law enforcement agencies and judicial authorities in that State on certain high priority matters (e.g. to combat money laundering, corruption, terrorism financing). Para 12.3 of the Commentary on Article 26 of the OECD Model Tax Convention further states that when a receiving State desires to use the information for an additional purpose (i.e. non-tax purpose), the receiving State should specify to the supplying State the other purpose for which it wishes to use the information and confirm that the receiving State can use the information for such other purpose under its laws. It also states that where the supplying State is in a position to do so, having regard to, amongst others, international agreements or other arrangements between the Contracting States relating to mutual assistance between other law enforcement agencies and judicial authorities, the competent authority of the supplying State would generally be expected to authorise such use for other purposes if the information can be used for similar purposes in the supplying State. Further, the law enforcement agencies and judicial authorities receiving information must treat that information as confidential in consistent with other provisions of the treaties.

4.5.3 Thus, the information received under the tax treaties can be used for non-tax purposes including for the purposes of combating money laundering, corruption and terrorist financing, if such use is permissible under the laws of the supplying State and the competent authority of the supplying State gives its consent for the same.

4.5.4 The provision for using the information for non-tax purposes with the consent of the competent authority of the supplying State was added in the OECD Model Tax Convention only in 2005 and accordingly in many of the older treaties this provision is not there. In such cases, normally the information cannot be used for non-tax purposes even with the consent of the supplying State as there is no legal authority for giving such consent.

4.5.5 Para 12.2 of the Commentary to the OECD Model Tax Convention also states that the information received by a Contracting State may not be disclosed to a third country unless there is an express provision in the bilateral treaty between the Contracting States allowing such disclosure. In most of the DTAAs, there is no provision for disclosing the information received to a third country and thus the information received under those DTAAs may not be further transmitted to a third country. Article 8 of the OECD Model TIEA of 2002 and Article 22(4) of the Multilateral Convention, however, provides that information received may be transmitted to a third country subject to the prior authorization from the Contracting State which originally provided the information.

4.6. DISCLOSURE OF INFORMATION TO TAXPAYERS AND THEIR PROXIES

4.6.1 Para 12 of the Commentary to Article 26 of the Model Tax Convention provides that the information received may be communicated to the taxpayers, his proxy or to the witnesses. However, while such disclosure is permitted, it is not required as it may raise an issue in certain cases, for instance where the information is given in confidence and the source of the information may have a legitimate interest in not disclosing it to the taxpayer. Similarly, the competent authorities may wish to keep confidential their correspondence with respect to any information exchanged. The competent authority supplying information should therefore indicate whether there are any objections to the disclosure of any part of the information provided (including any related correspondence) to the taxpayer, his proxy or to a witness. Where necessary the competent authorities should then discuss such issues with a view to finding a mutually acceptable solution.

4.6.2 Where the information is likely to be used against the taxpayer, it has to be provided to him for giving an opportunity of being heard. However, only the information which is relevant to him or is likely to be used against him should be provided to the taxpayer. The letter/ e-mail of the foreign Competent Authority may not be shared although the contents of the letter/ extracts may be shared. Similarly, the information which is used against the taxpayer may be made part of the assessment order. However, only the information which is relevant to the taxpayer and which is actually used against him should be included as part of the assessment order and the letter of the Competent Authority should not be made part of the assessment order, e.g. by scanning and pasting in the order, although the relevant contents of the letter/ extracts may be included.

4.6.3 Since information may be disclosed to the taxpayer or his proxy it may also be disclosed to any governmental or judicial authorities charged with deciding whether information should be released to the taxpayer. This case may arise in countries where a taxpayer who has been denied access to his files by the tax authorities has the right to apply for a review of that decision by a review or appeals body. Logically, this body has to see the information in order to render its decision.

4.7. DISCLOSURE OF INFORMATION PROVIDED IN A REQUEST

Para 11 of the Commentary on Article 26 of the OECD Model Tax Convention makes it clear that the confidentiality rules apply to all types of information, including both information provided

in a request and information transmitted in response to a request. Thus, the confidentiality rules cover the competent authority letters including the letter requesting information. The requested State is required to keep the information contained in the request letter confidential but it may disclose the minimum information contained in a competent authority letter (but not the letter itself) necessary for it to be able to obtain or provide the requested information to the requesting State, without frustrating the efforts of the requesting State. Para 11 of the Commentary on Article 26 of the OECD Model Tax Convention further adds that if court proceedings or the like under the domestic laws of the requested State necessitate the disclosure of the competent authority letter itself, the competent authority of the requested State may disclose such a letter unless the requesting State otherwise specifies.

4.8. SUSPENSION OF ASSISTANCE

Para 11 of the Commentary to Article 26 of the OECD Model Tax Convention provides that in situations in which the requested State determines that the requesting State does not comply with its duties regarding the confidentiality of the information exchanged under this Article, the requested State may suspend assistance under this Article until such time as proper assurance is given by the requesting State that those duties will indeed be respected. An example of this situation happened in the case of exchange of information between US and Japan in Aloe Vera case.

5. GUIDELINES FOR MAKING REQUEST FOR INFORMATION

5.1 The tax authorities during inquiry or investigation may require information which is available in a country/ jurisdiction outside India for instance in the following cases:

a. Assessing Officer making an inquiry for the purpose of obtaining full information in respect of the assets, income or loss of any person

b. Officers of the Investigation Wing carrying on further inquiry or investigation on the basis of evidence found in a search and seizure operation

c. The Transfer Pricing Officer (TPO) seeking further information on the functions performed, assets utilised and risks assumed by the respective associated enterprises, for the purposes of determining the Arm's Length Price

d. Officers of the International Taxation Wing determining the correctness of the withholding taxes reported in Form 15CA as payable under Section 195 of the Income-tax Act

e. Inquiry by Commissioner (Appeals)or Dispute Resolution Panel (DRP)either directly or through directions to the Assessing Officer, for the purposes of deciding appeals or objections

5.2 It is important for the tax authorities to make requests in a proper manner to enable the foreign country/ jurisdiction to provide assistance. If the requests are not properly framed, does not contain enough background material or is not understandable to the authorities in another jurisdiction, having a quite different legal and administrative system, they would not be able to provide assistance even if they fully intend to do so. Further, improper, defective or incomplete requests may result in seeking of clarifications by the requested jurisdiction and addressing these clarifications may lead to avoidable delays and hampering of investigations. Some of the key issues which the tax administration in the requesting jurisdiction must keep in mind before making a request are summarized below

5.2.1 Requests to be Made in Form "A" Prescribed in Manual on Exchange of Information

The request for EOI under tax treaties should be made in Form A (in duplicate), attached at the end as the Appendix to the Manual on Exchange of Information published by the CBDT in May, 2015 and being updated from time to time. Form A which in a fillable format is also available on the official website of the Income-tax Department, has two parts. Part I contains the basic information about the taxpayer under investigation in India and the officer(s) making the request while Part II is modeled on the lines of the template formulated by the OECD. Only Part II of Form A is forwarded to the foreign authorities and thus all the relevant information mentioned in covering letters, assessment orders etc. must be captured in Part II of Form A. The background note, summary of the case, factual analysis etc. should be included in Part II and if necessary, Annexures may be added to this Part of the Form. Since the information sent is treated as confidential by the tax authorities in other jurisdictions, copies of relevant incriminating documents seized can and should be enclosed if the same are considered useful for the foreign tax administration, in order to facilitate the obtaining of information by them. Detailed Instructions for filling up the Form have been provided with the Form itself. Where EOI requests are to be made in a group of cases under inquiry/ investigation, separate Forms should be filled up for different taxpayers. Further, separate Forms need to be filled up for EOI requests to different countries/ jurisdictions in the case of the same taxpayer. Thus, for instance, if three members of a family have received gifts from persons located in three different jurisdictions, the total number of Forms to be filled in would be nine.

5.2.2 Requests through the Competent Authority

The tax treaties authorize only the Competent Authority to exchange information and in fact place a legal obligation on them to do so. The tax authorities carrying on investigation or assessment in the requesting jurisdictions must, therefore, request information through the Competent Authority in their jurisdiction. The Competent Authority examines the request and satisfies itself that the conditions prescribed in the treaties are satisfied and only then a formal request is made to the other country/ jurisdiction. In appropriate cases, the Competent Authority seeks clarifications from the officers concerned and thus sufficient time must be available in the office of Competent Authority for processing the request. Since under the legal provisions of treaties, the exchange of information must take place between Competent Authorities, the tax authorities are not authorized to make a direct contact to their counterpart in other country/ jurisdiction. In India, as stated earlier, the Competent Authority for the purposes of tax treaties is Joint Secretary (FT&TR-I), CBDT, for North America (including Caribbean) and Europe while Joint Secretary (FT&TR-II), CBDT, is Competent Authority for the rest of the world.

5.2.3 Detailed Background and Demonstration of Foreseeable Relevance

The request should contain background of the investigation being carried out including summary of the case, factual analysis etc. This should be spelt out in as much detail as possible and copies of relevant incriminating documents produced by the taxpayers and/ or obtained during investigation including search and seizure should be annexed with the request. The tax authorities should also clearly demonstrate how the information received would be foreseeably relevant for the purposes of the treaties or for the administration and enforcement of the domestic laws. This will help the foreign tax authorities to provide the information requested, prevent legal challenges to proceedings in accessing information, if any, in the requested State, and will obviate the need for further clarifications on their part thereby also avoid delays.

5.2.4 Persons Under Investigation and Persons in Possession of Information

The request should clearly identify the person under investigation and all the relevant details available such as name, Taxpayer Identification Number (in either or both jurisdictions), date of birth/ date of incorporation, full address (in either or both jurisdictions) etc. should be provided in the request. Further, details about foreign taxpayers related to the person under investigation/ examination, as available in the records, and which may be of assistance to the foreign tax authorities in providing the information, may also be clearly mentioned. The name and address (to the extent known) of the person believed to be in possession of the information should also be mentioned in the request for providing assistance to the foreign tax authorities to locate the information quickly. This could be name and address of the Bank (in case of bank accounts), tax administration of the other country (in case of return of income or taxes paid), name and address of agents/ service providers (in case of say financial accounts requested from offshore financial centres) etc.

5.2.5 Request to Refrain from Notification

Under the laws of certain countries/ jurisdictions, the taxpayer or the holder of the information has certain rights including a right to be informed or notified that a request concerning him for information under a tax treaty has been made. The requesting country, however, in certain exceptional cases can make a request that the taxpayer/ holder of information may not be so notified. If a request to refrain from notifying the taxpayer(s) concerned is made, the reasons for the same must be clearly explained. Such reasons could be that the information is of a very urgent nature and the process of prior notification to the taxpayer will delay supply of information or the prior notification is likely to undermine the success of the investigation being conducted. A request to refrain from notifying the taxpayer should not be made in a routine manner and such request should be made only if it is essential and can be justified on the basis of documentary evidence. The reason that the taxpayer concerned is likely to file an appeal against the supply of information may not be a valid reason for making such a request.

5.2.6 Multi-level Enquiry Necessary in Some Cases

As per the currently agreed international standards, the Contracting States/ Parties are obliged to exchange information which is held by the jurisdiction or is within the possession or control of persons within the jurisdiction's territorial jurisdiction. This creates a limitation on exchanged information in multi-level investigations involving entities located in more than one jurisdiction. For instance, if a request is made to jurisdiction A to provide ownership information of a company resident in A, and if it gives the information that the owners of company are residents of country B, then further enquiry will have to be made from country B to identify the next level of ownership. Similar enquiry may be necessitated in case of flow of funds. Thus, in many cases, complete information may not be obtained through requests made to one jurisdiction and may require follow up requests to other jurisdictions to take the investigation to its logical end.

5.2.7 Enumerate Requirements in Simple Language

The information requested should be specific and should be described as clearly as possible. The language should be simple and easily understandable to foreign tax authorities who may not be aware of the requesting jurisdiction's tax laws and procedures or the terminology used. The questions should be framed in such a manner that they can be answered directly on the basis of documents or other information available and the details requested should be specific. Request for voluminous information should be avoided as it may become counterproductive on account of the following reasons:

- The request may be considered as having been made in a casual and perfunctory manner and may be responded to accordingly by the foreign tax authorities.
- More critical information which is actually required, may be missed by the foreign tax authorities in a request with a long list of questions and the useful information may not be received.
- Though the foreign tax authorities may be genuinely trying to provide assistance, they may not be able to do so as they would need to collect the requested information from various sources which they may not be able to do in a timely manner.
- Seeking unnecessary details in a casual manner without due consideration of the effort that may be required on the part of treaty partner, may be viewed unfavourably and may also adversely affect the reputation of the requesting jurisdiction and may also adversely impact on its ability and moral authority to seek information even in genuine cases.

5.2.8 Efforts to Obtain Information from Taxpayers

Before making the requests, all possible means available should be pursued to obtain the required information in the requesting jurisdiction through the taxpayer or otherwise and these efforts should be clearly mentioned in the request. As seen earlier, one of the factors that establishes foreseeable relevance of a request is a declaration that needs to be given with the request that the requesting country has pursued all means available in its own territory to obtain the information except those that would give rise to disproportionate difficulties and thus this aspect must be kept in mind before making the request. Further, in many cases, the taxpayer itself or its related entity in the other country may be able to provide the information which is requested from a foreign country/ jurisdiction. In these cases, before making the request, the taxpayer should be asked to produce the documents and only when the taxpayer states that he cannot produce the same as it is not available with him or could not obtain from its related entities, a request should be made to a foreign country. This fact of not producing the document by the taxpayer, even if it could have done so after taking reasonable measures and without disproportionate difficulties, should be mentioned in the assessment order finally passed so that the default of the taxpayer is clearly established.

5.2.9 Publicly Available Information

Before making a request, efforts should be made to obtain the required information from publicly available sources in the other country/ jurisdiction, such as public data bases maintained by regulators in foreign jurisdictions (similar to database maintained by the Registrar of Companies in case of India and available at www.mca.gov.in). These public databases can provide considerable information such as registration details, ownership information, financial statements, annual reports etc. which need not be again requested through a request for EOI. The information contained in these public databases may also help in making more focused references and may provide clues for asking the relevant questions for example about beneficial ownership of legal entities/ arrangements which may not be publicly available. Focused and relevant questions, rather than a long list of information some of which is publicly available, will enable the foreign authorities to provide assistance in a more meaningful manner. The websites on which the information may be publicly available for some selected countries/ jurisdictions as also some general websites as provided in the Manual on Exchange of Information issued by the CBDT is provided in Box 7.1.

Box 7.1: Publicly Available Information which may be Accessed before Making a Request for Information

a. Guernsey [https://www.greg.gg/webCompSearch.aspx]

This website can be used to quickly obtain details of companies and limited partnerships registered in Guernsey. For a small fee, information such as the legal ownership of a Guernsey registered company may be obtained, as well as copies of documents such as the Memorandum of Association and Articles of Association. It should, however, be stressed that whilst the shareholders of a company may be nominees, all companies are required to have a Resident Agent, who must hold details of the beneficial ownership of the company. In order to obtain the beneficial ownership details it may, therefore, be necessary for the Director to formally require the company/ resident agent to provide this information.

b. Cayman Island [www.ciregistry.gov.ky]

On this website, verification of a Cayman Islands' company registration can be done by clicking on the "search Company" feature. Upon payment of the requisite fee, the details are provided. One may apply for a CIGnet account to pay for the service[http://www.gov.ky/portal/ page?_pageid=1142,5064144&_dad=portal&_schema=PORTAL]. The website provides a list of the names of the companies that have been struck off the register during this year and there is no fee for this information. [http://www.ciregistry.gov.ky/portal/page?_pageid=3521,8625893&_dad=portal&_schema=portal]

c. Isle of Man [http://portal.gov.im/pvi/CompanySearch.aspx]

On this website, the name of Isle of Man Company can be searched. If the company is there in the company registry, documents like annual return, change in directors, mortgage register, change in address, memorandum of satisfaction etc. related to the company can be downloaded after payment of requisite fees.

d. Jersey [https://www.jerseyfsc.org/registry/documentsearch/]

On this website, the name of the company can be searched and then relevant documents can be downloaded after payment of requisite fees.

e Liechtenstein [http://www.oera.li/hrweb/ger/firmensuche_afj.htm]

Information on companies, foundations etc. registered in the Commercial Register of Liechtenstein can be found on this website.

f. Hong Kong [http://www.icris.cr.gov.hk/csci/]

Company Name Search, Company Particulars Search, Image Record Search (including Document Index Search), Directors Index Search, Register of Charges Search, Register of Disqualification Orders Search etc. are available on this website.

g. Singapore [https://www.acra.gov.sg/home/]

This website offers free as well as paid information regarding companies registered in Singapore. Profile of the company as well as financial statements may be obtained on payment basis.

h. USA [https://www.sec.gov/edgar/searchedgar/companysearch.html]

The Securities Exchange Commission website gives the quarterly, annual reports filed by listed corporations, as well as reports of change in beneficial ownership are also provided. The search facility

is fairly simple as it is based only on the name of the company of interest.

i. Cyprus[http://www.mcit.gov.cy/mcit/drcor/drcor.nsf/index_en/index_en?OpenDocument#]

This website provides information of companies registered in Cyprus.

j. U.A.E. [http://www.dfsa.ae/PublicReqister/Default.aspx]

The above website is a public register of Dubai Firms.

k. Companies Register of Member States of European Commission [https://ejustice.europa.eu/content_business_registers_in_member_states-106-en.do]

This website contains basic details of companies registered in Member States of European Commission such as name, date of incorporation, list of directors etc. free of cost. The financial statements such as Profit and Loss Account and Balance Sheet can also be obtained by making the necessary payments.

l. Compilation of various online Companies Registries/ Government Websites, by 'Open Knowledge Foundation' (OKFN) [index.okfn.org/dataset/companies/]

The OKFN site lists out the Government Websites of various countries (100+ countries) from which their respective 'Companies Registry' may be accessed. It gives information on whether the access to company data is free ($ Sign in 'green' color) or on payment basis ($ Sign in 'red' color). Further, most of the websites, whose links are provided in the OKFN website, also provide "bulk data", for example, the entire companies' register of a particular country, that may be downloaded.

m. Amadeus provides a database of comparable financial information for public and private companies across Europe which may be seen at https://amadeus.bvdinfo.com

n. A detailed list of companies' registers for various countries is also complied at http://en.wikipedia.org/wiki/List_of_company_registers

o. Financial statements, financial ratio and other business statistics is provided free of charge at http://www.bizstats.com/

p International white and yellow pages can be accessed at www.wayp.com

5.3 CERTAIN KEY RESULTS OF EXCHANGE OF INFORMATION ON REQUEST

The Manual on Exchange of Information issued by the Central Board of Direct Taxes in May, 2015, provides illustrative examples/ case studies on requests made in India under Exchange of Information which demonstrates the usefulness of the major information Clause in tackling tax evasion and avoidance. These illustrative examples/ case studies are as under:

a. Brokerage and commission claimed to have been paid to companies located in foreign countries were found to be not for the purposes of business as (i) some companies were not found doing any business and were registered at offices of chartered accountants (ii) some companies although doing business had not done any advertisement or marketing for the products for which the commissions were allegedly paid. Further, the promoters and/ or directors of these foreign companies were persons closely related to the Indian promoter. Information was requested and received from four of the treaty partners.

b. Gifts from foreign persons were received in the bank account of an Indian taxpayer and it was ascertained from the information provided by our treaty partners that these foreign persons had no capacity to make such huge amounts of gift. In another cases, similar information received from foreign countries about loans from persons in foreign jurisdictions were not found to be genuine.

c. During a survey operation, it was found that an Indian taxpayer frequently travels abroad and spends a lot of money. Details of credit cards issued in a foreign country in the name of other persons were found. The credit card statements were received from the foreign country under the EOI provisions of the treaty and it was noted that huge amounts were spent by the Indian taxpayer through these credit cards.

d. Information about a bank account held by the taxpayer in country "A" was available. Information provided by country "A" about the details of transactions and the narrations thereof established existence of bank accounts in a number of countries, including in the name of family members. Requests for further information were made to other countries and information provided by them resulted in unearthing of substantial unaccounted income in the name of the taxpayer and their family members.

e. Commission received by the Indian taxpayer for services rendered in a foreign country was not disclosed in the tax return, the details of which were received under "spontaneous exchange of information" and the same was brought to tax after making further requests under EOI.

f. A small amount of commission received by an Indian taxpayer in a foreign country was reported by that country under the "automatic exchange of information" route. Requests for full details of bank accounts and other information were made under the treaty and the information received disclosed substantial amount of tax evaded income.

g. During a search and seizure operation, information about foreign bank accounts and trading in foreign commodity market was found. The bank statements and detail of trading were provided by the country concerned under the provisions of the tax treaty resulting in unearthing of substantial amount of unaccounted income.

h. During a search and seizure operation in the case of an Indian taxpayer, information about bank accounts and immovable properties in foreign countries was found. Further information received under exchange of information through the treaty showed that these bank accounts and immovable properties were owned by companies located in a third country. Information was then requested from the third country, which showed that the companies are beneficially owned by persons related to the Indian taxpayer.

i. During a search and seizure operation in the case of an Indian taxpayer, details of bank accounts in foreign countries were found including in the name of a trust. Information received from the jurisdiction where the trust is located, showed that the beneficial owner of the trust is the Indian taxpayer.

j. Information in a number of cases received from an offshore financial centre about companies registered in that jurisdiction have shown that the Indian taxpayers are shareholders/ beneficial owners/ controlling persons of the companies that maintained bank accounts or made investments in other countries. In many

cases, existence of such companies and/ or relationship with the companies had been denied initially by the Indian taxpayers.

k. In a number of cases, information about trustees and beneficiaries of foreign trusts including trust deeds and KYC documents have been received, demonstrating connection with Indian taxpayers.

6. OTHER FORMS OF EXCHANGE OF INFORMATION

6.1 Overview

6.1.1 Tax Treaties including DTAAs, TIEAs and MAC have provisions for providing administrative assistance in a number of other ways also in addition to the exchange of information on request basis. These forms of administrative assistance includes automatic exchange of information, spontaneous exchange of information, tax examination abroad, simultaneous examination, industry-wide exchange of information, joint audits and service of documents and will be discussed in the present Chapter. Assistance in recovery of taxes including conservancy measures is also possible in some of the tax treaties and the same will be discussed in the next Section of this Chapter.

6.1.2 Para 9 of the Commentary on Article 26 of the OECD Model Tax Convention states that the rules laid down in Article 26(1), i.e., to exchange information which is foresee ably relevant, allows information to be exchanged in three different ways, i.e. (a) on request (b) automatically and (c) spontaneously. Para 9.1 of the Commentary further states that Article 26 does not restrict the possibilities of exchanging information to these methods and that the Contracting States may use other techniques to obtain information which may be relevant to both Contracting States such as simultaneous examinations, tax examinations abroad and industry-wide exchange of information.

6.1.3 Article 5 of the OECD Model TIEA provides for exchange of information only on request basis. The commentary to Article 5 of the OECD Model TIEA makes it clear that the agreement does not cover automatic or spontaneous exchange of information unless the contracting parties have expanded their co-operation in matters of information exchange for tax purposes by covering automatic and spontaneous exchanges and simultaneous tax examinations. In June 2015, the OECD released a Model Protocol to the Model TIEA of 2002 which may be used by jurisdictions for extending the scope of their existing TIEAs to also cover the automatic and/ or spontaneous exchange of information. The OECD Model TIEA, however, does have a specific provision for tax examination abroad in Article 6 in a comprehensive manner.

6.1.4 The MAC has specific Articles for exchange of information on request (Article 5), automatic exchange of information (Article 6), spontaneous exchange of information (Article 7), simultaneous tax examinations (Article 7) and tax examination abroad (Article 8) in addition to provisions for recovery of taxes and conservancy (Articles 11 and 12) and Article 17 (service of documents).

6.2. AUTOMATIC EXCHANGE OF INFORMATION

6.2.1 The automatic or routine exchange of information is systematic and periodic transmission of "bulk" taxpayer information by the source country to the residence country concerning various categories of income (e.g. dividends, interest, royalties, salaries, pensions, etc.) without residence country making a request for such information. The information which is exchanged automatically is normally collected in the source country on a routine basis, generally through reporting of the payments by the payer (financial institution, employer, etc.), which on transmission may be checked by the tax authorities of the taxpayer's country of residence

to verify whether taxpayers have accurately reported their foreign source income. Automatic exchange can also be used to transmit other types of useful information such as changes of residence, the purchase or disposition of immovable property, value added tax refunds, etc. and is a useful tool for improving compliance in the residence country. Despite automatic exchange being possible under the provisions of DTAAs, MAC and some regional multilateral agreements such as amongst Nordic countries, and despite its benefits in improving compliance, it was not so prevalent.

6.2.2 The opportunities provided by automatic exchange of information got a renewed focus from 2012 by G20 countries and by enactment of Foreign Account Tax Compliance Act (FATCA) by USA. FATCA required the Foreign Financial Institutions (FFIs) to enter into an agreement with the US-IRS to provide information about accounts held with them by USA persons or entities controlled by USA persons or in the alternative face 30% withholding on all US source payments. To implement FATCA and with a view to improve International Tax Compliance, five countries (France, Germany, Italy, Spain and the United Kingdom) decided to enter into Inter Governmental Agreement (IGA) with USA. The Financial Institutions in the respective countries were required to submit the information required under FATCA to the tax authorities of their own country which is transmitted to USA on an automatic basis under the IGA. The US-IRS is also required to transmit certain information about the tax residents of those countries under the IGA although the scope of information exchanged was not fully reciprocal. The underlying legal instrument for this automatic exchange of information was the DTAA between USA and the respective countries. Subsequently, USA entered into IGAs with more than 100 countries/ jurisdictions to exchange the information on an automatic basis.

6.2.3 More importantly, FATCA and IGA were used to develop a uniform standard for exchanging financial accounts information on an automatic basis. On 19th April 2013 the G20 Finance Ministers and Central Bank Governors endorsed automatic exchange as the expected new standard and made a formal request to the OECD to report on progress in developing a new multilateral standard on automatic exchange of information. By February 2014, the OECD agreed on the text of the Common Reporting Standard (CRS) and in June 2014 the full CRS, including the commentaries and the XML Schema, was approved by the OECD and was subsequently endorsed by the G20 in September 2014.

6.2.4 The new standards require the source jurisdiction to collect certain information from the financial institutions residents in their jurisdiction and transmit the same to the jurisdiction in which the taxpayer is resident in accordance with a Competent Authority Agreement (CAA). The standards include model CAA which may be entered on a bilateral basis with the underlying legal instrument being DTAA or TIEA or on a multilateral basis where the underlying legal instrument is the MAC. The multilateral version of the CAA, known as Multilateral Competent Authority Agreement (MCAA), have been signed by quite a few countries/ jurisdictions. Also 101 jurisdictions have committed to implement the CRS by 2017 or 2018 and it is expected that by the end of the decade, the new global standards on automatic exchange of information is fully implemented at the global level.

6.2.5 The mechanism of automatic exchange of information is also being travelling to exchange the Country-by-country Reports (CbC Reports) which is required to be filed by the Multi National Enterprises (MNEs) in their resident country under Action 13 of the G20/ OECD Project on Base Erosion and Profit Shifting (BEPS). The underlying instrument

which facilitates this automatic exchange is MAC (on multilateral basis) or the DTAAs and TIEAs (on bilateral basis). The OECD has developed a CbC-MCAA based on the MAC setting forth the rules and procedures for exchange of CbC reports and 51 jurisdictions have signed the said CbC-MCAA. The purpose of the CbC MCAA is to set forth rules and procedures as may be necessary for Competent Authorities of jurisdictions implementing BEPS Action 13 to automatically exchange CbC Reports prepared by the Reporting Entity of an MNE Group and filed on an annual basis with the tax authorities of the jurisdiction of tax residence of that entity with the tax authorities of all jurisdictions in which the MNE Group operates.

6.3 SPONTANEOUS EXCHANGE OF INFORMATION

6.3.1 Information is exchanged spontaneously when one of the Contracting State/ Party, having obtained information which it assumes will be of interest to another Contracting State/ Party, passes on this information without the latter having asked for it. A spontaneous exchange of information could be more effective since it concerns particulars detected and selected by tax officials of the sending jurisdiction during or after an audit or other type of tax investigation.

6.3.2 Para 9 of the Commentary on Article 26 of the OECD Model Convention provides that the information which is foresee ably relevant to the other Contracting State may be provided on a spontaneous basis even in absence of a specific request. Article 7 of the MAC provides that a Party shall, without prior request, forward to another Party information of which it has knowledge in the following circumstances:

a. Grounds for suspecting that there may be a significant loss of tax in the other country;
b. a person liable to tax obtains a reduction in, or an exemption from, tax in one country which could give rise to an increase in tax liability in another country;
c. business dealings between a person liable to tax in a country and a person liable to tax in another country are conducted through one or more countries in such a way that a saving in tax may result in one of the other countries or in both;
d. a country has grounds for suspecting that a tax saving may result from artificial transfers of profits within groups of enterprises; and
e. information forwarded to a country by another country has enabled information to be obtained which may be relevant in assessing liability to tax in another country.

6.3.3 Action 5 of the G20/ OECDBEPS project provides for the compulsory spontaneous exchange of information on certain categories of taxpayer specific rulings and applies to rulings given both pre- and post-transaction. Taxpayer-specific rulings have been defined as "rulings that apply to a specific taxpayer and on which that taxpayer is entitled to rely". The Report on Action 5 confirms agreement on a framework covering all rulings for compulsory spontaneous exchange of information covering the following six categories of rulings:

a. Cross-border rulings related to preferential regimes.
b. Cross-border unilateral APAs or other cross-border unilateral tax rulings covering transfer pricing or the application of transfer pricing principles.
c. Cross-border rulings that provide for a unilateral downward adjustment to a taxpayer's taxable profits that is not directly reflected in the taxpayer's financial or commercial accounts. It has also been agreed to exchange information under this category on unilateral downward adjustments made by taxpayers under informal capital contribution or excess

profit regimes even where no ruling has been issued by the tax authority.

d. PE rulings. These are rulings that concern the existence or absence of a PE or the attribution of profits to a PE.

e. Related Party Conduit Rulings. This refers to rulings which are given in respect of cross-border flows of funds or income through an entity in the country giving the ruling, involving a flow of funds or income to another country either directly or indirectly.

f. any other type of ruling where the FHTP agrees in the future that the absence of exchange would give rise to BEPS concerns.

6.4 TAX EXAMINATIONS ABROAD

6.4.1 Tax examination abroad allows for the possibility to obtain information through the presence of representatives of the competent authority of the requesting competent authority. It enables the tax administrations, when requested and to the extent allowable by its domestic law, to permit authorised tax officials of another country to participate in the conduct of tax examinations carried out by the requested country. Further, in order to be able to ascertain a clear and complete picture of business and other relations between a resident of a Party who is the subject of a tax examination and his foreign associates, it is often of great value to be able to follow at close proximity an examination initiated in the foreign country and tax examination abroad would be useful in such situations.

6.4.2 Tax examinations abroad may also reduce the compliance burden for taxpayers by enabling tax administrations to work together, rather than independently, on issues regarding the same taxpayer or taxpayer group. Such cooperation ensures duplication is minimised or avoided altogether, costs are reduced and time is saved, all of which flow as advantages to the taxpayer.

6.4.3 Para 9.1 of the Commentary on Article 26 of the OECD Model Tax Convention allows the Contracting States to engage in tax examination abroad and states that to the extent allowed by its domestic law, a Contracting State may permit authorised representatives of the other Contracting State to enter the first Contracting State to interview individuals or examine a person's books and records, or to be present at such interviews or examinations carried out by the tax authorities of the first Contracting State, in accordance with procedures mutually agreed upon by the competent authorities.

6.4.4 Article 9 of the MAC also provides for Tax Examination Abroad under which at the request of the competent authority of the applicant State, the competent authority of the requested State may allow representatives of the competent authority of the applicant State to be present at the appropriate part of a tax examination in the requested State.

6.4.5 Article 6 of the OECD Model TIEA of 2002 provides the legal basis for "Tax Examination Abroad" which can take place in the following manner:

a. A Contracting Party may allow representatives of the applicant Party to enter the territory of the requested Party to interview individuals and to examine records with the written consent of the persons concerned to enable officials of the applicant Party to participate directly in gathering information in the requested Party.

b. A Contracting Party may permit the presence of foreign tax officials to be present during a tax examination initiated by the requested Party in its jurisdiction, for example, for purposes of obtaining the requested information.

6.4.6 The first form of tax examination abroad where a Contracting Party may allow representatives of the applicant Party to enter

the territory of the requested Party to interview individuals and to examine records with the written consent of the persons concerned was first introduced in the OECD Model TIEA of 2002 on the grounds that many jurisdictions and smaller countries have limited resources with which to respond to requests, this provision can be a useful alternative to the use of their own resources to gather information. The decision of whether to allow such examinations and if so on what terms, lies exclusively in the hands of the requested Party. For instance, the requested Party may determine that a representative of the requested Party is present at some or all such interviews or examinations. This provision enables officials of the applicant Party to participate directly in gathering information in the requested Party but only with the permission of the requested Party and the consent of the persons concerned. Officials of the applicant Party would have no authority to compel disclosure of any information in those circumstances.

6.4.7 The second form of tax examination abroad authorises the requested Party to permit the presence of foreign tax officials to be present during a tax examination initiated by the requested Party in its jurisdiction, for example, for purposes of obtaining the requested information. The decision of whether to allow the foreign representatives to be present lies exclusively within the hands of the competent authority of the requested Party.

6.4.8 The participation of authorised foreign tax officials in a tax examination being carried out by the requested country may be passive or active. Some countries may only permit passive participation of foreign tax officials in a tax examination. In such instances, participation by foreign tax officials would be limited to observing relevant parts of the tax examination and only liaising directly with the tax officials of the requested country. Foreign tax officials would not be permitted to directly interview taxpayers or other individuals under this form of tax examination abroad. Other countries may permit active participation of authorised foreign tax officials. Under such circumstances, some countries may, for example, allow foreign tax officials to conduct interviews and examine records pertaining to the taxpayers under examination. Tax examinations of this nature are useful in situations where the laws enable the taxpayer to keep records in another country and the taxpayer has agreed to have the tax official come to the foreign country rather than provide the books and records in the taxpayer's country.

6.5 SIMULTANEOUS TAX EXAMINATION

6.5.1 A simultaneous tax examination is an arrangement by two or more countries to examine simultaneously and independently, each on its territory, the tax affairs of a taxpayer or a number of taxpayers in which they have a common or related interest with a view to exchanging any relevant information which they so obtain. Para 9.1 of the Commentary on Article 26 of the OECD Model Tax Convention allows the Contracting States to have simultaneous tax examination which is also possible under Article 8 of MAC.

6.5.2 In cases where international tax avoidance and evasion is suspected, simultaneous tax examinations can be very effective compliance and control tools for tax administrations. It can also help to eliminate economic double taxation and to discover aggressive tax planning arrangements. Simultaneous tax examinations is likely to prove particularly useful when dealing with transactions between associated enterprises (and determining arm's-length prices) and accordingly in Para 4.92 of the OECD Transfer Pricing Guidelines, the greater use of simultaneous tax examination has been recommended in the examination of transfer pricing cases and to facilitate exchange of information and the operation of mutual agreement procedure.

6.5.3 The OECD Transfer Pricing Guidelines also states that simultaneous tax examinations may be a useful instrument to determine the correct tax liability of associated enterprises in cases where, for example, costs are shared or charged and profits are allocated between taxpayers in different taxing jurisdictions or more generally where transfer pricing issues are involved. Simultaneous tax examinations may facilitate an exchange of information on multinational business practices, complex transactions, cost contribution arrangements, and profit allocation methods in special fields such as global trading and innovative financial transactions. As a result, tax administrations may acquire a better understanding of and insight into the overall activities of an MNE and obtain extended possibilities of comparison and checking international transactions. Obtaining the necessary information and determining the facts and circumstances about such matters as the transfer pricing conditions of controlled transactions between associated enterprises in two or more tax jurisdictions may be difficult for a tax administration, especially in cases where the taxpayer in its jurisdiction does not cooperate or fails to provide the necessary information in due time. The OECD Manual on Transfer Pricing, therefore, states that the simultaneous tax examination process can help tax administrations to establish these facts faster and more effectively and economically.

6.5.4 Simultaneous tax examinations also ensure high levels of efficiency regarding the exchange of information between tax jurisdictions and enable a comprehensive review of all relevant business activities. Simultaneous tax examinations may reduce the compliance burden for taxpayers by co-ordinating enquiries from different States' tax authorities and avoiding duplication. They can also play a role in averting double taxation and thus prevent the need to subsequently resort to a mutual agreement procedure under a provision similar to Article 25 of the OECD Model Tax Convention.

6.6 INDUSTRY-WIDE EXCHANGE OF INFORMATION

6.6.1 An industry-wide exchange of information is the exchange of tax information specifically concerning a whole economic sector and not taxpayers in particular. The purpose of such an exchange is to secure comprehensive data on worldwide industry practices and operating patterns, enabling tax inspectors to conduct more knowledgeable and effective examinations of industry taxpayers. It also provides an opportunity to the competent authorities of the Contracting States to discuss the ways in which a particular economic sector operates, the financing schemes, the ways process are determined, the tax evasion trends identified etc.

6.6.2 Para 9.1 of the Commentary on Article 26 of the OECD Model Tax Convention allows the Contracting States to have industry-wide exchange of information, i.e., exchange of tax information concerning a whole economic sector (e.g. the oil or pharmaceutical industry, the banking sector, etc.) and not taxpayers in particular.

6.6.3 An industry-wide exchange of information typically does not involve discussions of the specific financial affairs of particular taxpayers. However, subsequent requests may be made by a participating treaty partner for specific taxpayer information in accordance with the applicable information exchange instrument. These specific requests supplement an industry-wide exchange and may lead on to a simultaneous tax examination of a taxpayer operating within the covered industry and active in both treaty partner jurisdictions.

6.6.4 An industry-wide exchange of information is initiated by way of a formal exchange of letters between the competent authorities of the participating treaty partners and such exchanges may be bilateral or multilateral, provided all countries taking part have adequate information exchange mechanisms with one another. The

OECD Manual on Exchange of Information, Module 4 on industry-wide exchange of information, states that industries such as Banking, Commodities, Electronic components, Fishing, Information technology, Insurance, Oil and gas, Pharmaceuticals, Telecommunications and Utilities are known to have been covered in various industry-wide exchanges of information between OECD member countries.

6.7 JOINT AUDITS

A joint audit can be described as two or more countries joining together to form a single audit team to examine an issue(s)/ transaction(s) of one or more related taxable persons (both legal entities and individuals) with cross-border business activities, perhaps including cross-border transactions involving related affiliated companies organized in the participating countries, and in which the countries have a common or complementary interest; where the taxpayer jointly makes presentations and shares information with the countries, and the team includes Competent Authority representatives from each country who are involved to resolve potential differences/ stalemates. The term "joint audit" as such is not a legal term and used in practice to express the idea that two or more tax administrations work together under the legal framework of bilateral and multilateral tax treaties such as DTAAs and MAC.

6.8 SERVICE OF DOCUMENTS

6.8.1 Assistance in the form of service of documents including judicial decisions have not been specifically mentioned in tax treaties such as DTAAs and TIEAs although countries do provide assistance to each other in service of documents through Mutual Legal Assistance Treaties or through diplomatic channels.

6.8.2 Article 17 of the MAC provides that at the request of the applicant State, the requested State shall serve upon the addressee documents, including those relating to judicial decisions, which emanate from the applicant State and which relate to a tax covered by the Convention. The service of documents will be effected by the requested State as if they were its own documents, that is to say by a method prescribed by its domestic laws for documents of a substantially similar nature. There are cases, however, where the applicant State has a preference for a certain method of service. Such a preference may be expressed when sending the request for assistance. The requested State shall then effect service of documents accordingly, insofar as the method requested by the applicant State is available under its own laws. If not, it will make use of the closest method available under its domestic laws.

6.8.3 The purpose of the provision is to ensure that as far as possible documents such as notices of assessment or reminders actually reach the taxpayer, in order to avoid enforcement steps being taken against a taxpayer who is genuinely ignorant of the tax claim or is merely neglectful. Documents shall be served if required for the activities of the tax authorities or for the protection of taxpayers.

6.8.4 Article 17(3) of the MAC provides that a Party may effect service of documents directly through the post on a person within the territory of another Party. This provision has been introduced to prevent extra workload of the two tax administrations and the resultant delays. In most of the countries, direct service of documents may not present any problems. However, in some countries, sending by post of official documents of another country to its residents may be considered as an infringement of its sovereignty and in those countries, service of documents through direct postal service may not be possible. In these cases, the countries concerned may put a reservation stating that they cannot allow direct service of documents through postal services. The MAC has been joined by the end

of 2016 by more than 65 countries/ jurisdictions and the reservation on this count has been given only by Albania, Argentina, Brazil, Costa Rica, Mexico, Isle of Man, Guernsey and Uruguay and thus in other countries, documents can be sent directly through post.

6.8.5 Article 17(4) of the MAC also provides that neither the provisions of Article 17 nor anything else in the Convention is intended to prevent a Contracting State from using its own procedures for the service of documents in its own territory or in another State, if that is possible under the laws of that other State – or to invalidate the use of such procedures. This is of special interest to applicant States which may serve documents in other ways (for example, service on a representative of the taxpayer in the territory of that State or service by public notice). Although such methods of service do not necessarily guarantee that the taxpayer actually receives a notification, their usual effect is that he is deemed to have received it.

CHAPTER

7

Commodity Markets

1. Commodities market, commodities trading, commodity futures... These terms are not very commonly understood by many. However, commodity markets offer as much an opportunity to investors as does the stock market.

2. WHAT IS THE COMMODITY MARKET?

Commodity market is a place where trading in commodities takes place. It is similar to an equity market, but instead of buying or selling shares one buys or sells commodities.

3. HISTORY OF COMMODITY FUTURES TRADING IN INDIA

Commodities futures trading in India can be traced back to more than one century. Perhaps the first organised futures market in India was established as the Bombay Cotton Trade Association in 1875, which permitted trade in cotton derivatives contracts. In the pre-independence era, the principal commodity markets were Bombay, Karachi, Ahmedabad and Indore. The wheat markets of Bombay, Hapur, Karachi, Lyallpur, Amritsar, Okara and Calcutta; the groundnut markets of Madras and Bombay; the linseed markets of Bombay and Calcutta; Jute and Hessian markets of Calcutta; Bullion markets of Bombay, Calcutta, Delhi and Amritsar and sugar markets of Bombay, Calcutta, Kanpur and Muzaffarnagar were all prominent. There were no standard regulations governing these markets. After Independence, the government banned cash settlement and options trading. The governance of all commodity derivatives contracts were brought under the FCRA. Towards the end of the sixties, a period of prolonged drought caused crop failure with several farmers defaulting on their obligations. This led to supply shortages and soaring prices in agricultural commodities. There was both an explicit economic and social shock: among these high prices for their commodities, there were a large number of farmers who committed suicide because of their default on delivering goods. Such a stress in the system led the government to ban trading of futures contracts. In the seventies, futures trading on commodities was permitted again, starting with a small set of non-essential commodities. By then, trading had moved underground to

OTC contracts and volumes never reached their pre-ban levels. Even today, it is said that the underground OTC market dwarfs the liquidity of the visible exchanges. In the traditional Indian commodity derivatives markets, instead of one exchange trading multiple commodities, each commodity would have multiple exchanges. Each exchange would be setup in, or close to, the region where the commodity was produced and were associations of brokers.

3.1 Today, with the liberalisation of the financial sector in India, commodity derivative markets are very different. Reforms have seen a more significant development of institutions that enable a manifold increase in the size and accessibility of commodity derivatives in India. These developments started at the end of 2003, and the commodities markets are still in the process of transition towards equilibrium between the spot and the futures markets. For example, a decade after the first reforms, there were a total of 24 exchanges, some of which were the large, national, multi-commodity exchanges, and others served a more local base of users. Each exchange today can trade multiple commodities on the same platform.

3.2 There are three major electronic exchanges today, which offer a single trading and clearing platform across the nation. These are: The National Multi-Commodities Exchange (NMCE) in Ahmedabad, Multi Commodities exchange (MCX) in Bombay and National Commodities Derivatives Exchange (NCDEX) in Bombay. These exchanges are managed professionally and owned by financial entities, rather than by the brokers, as used to be the case before the recent reforms. These can include foreign ownership as well. For example, Fidelity International is a shareholder in MCX and the Goldman Sachs Group has invested in NCDEX. These new exchanges trade multiple commodities. When a commodity trades on one of the new national exchanges, traded volumes tend to move away from the traditional local exchange that used to previously be the Centre of liquidity for that commodity, onto the new national exchange. Of all the exchanges, MCX and NCDEX, account for the traded volume of the 10 most active contracts. NCDEX dominates in the traded volumes of the agricultural contracts. However, agricultural contracts accounted for only around 12% of total volume.

4. WHAT ARE THE DIFFERENT TYPES OF COMMODITIES THAT ARE TRADED IN THESE MARKETS?

World-over one will find that a market exists for almost all the commodities known to us. These commodities can be broadly classified into the following:

- Precious Metals: Gold, Silver, Platinum, etc.
- Other Metals: Nickel, Aluminum, Copper, etc.
- Agro-Based Commodities: Wheat, Corn, Cotton, Oils, Oilseeds, etc.
- Soft Commodities: Coffee, Cocoa, Sugar, etc.
- Live-Stock: Live Cattle, Pork Bellies, etc.
- Energy: Crude Oil, Natural Gas, Gasoline, etc.

5. WHAT ARE THE DIFFERENT SEGMENTS IN THE COMMODITIES MARKET?

The commodities market exists in two distinct forms, namely, the Over the Counter (OTC) market and the exchange-based market. Also, as in equities, there exists the spot and the derivatives segment. The spot markets are essentially over-the-counter markets and the participation is restricted to people who are involved with that commodity, say, the farmer, processor, wholesaler, etc. A majority of the derivative trading takes place through exchange-based markets with standardised contracts, settlements, etc.

6. WHAT ARE THE CHARACTERISTICS OF OVER THE COUNTER (OTC) COMMODITY MARKETS?

The OTC markets are essentially spot markets and are localised for specific commodities. Almost all the trading that takes place in these markets is delivery based. The buyers as well as the sellers have their set of brokers who negotiate the prices for them. This can be illustrated with the help of the following example:

A farmer, who produces castor, wishing to sell his produce, would go to the local 'mandi.' There he would contact his broker who would in turn contact the brokers representing the buyers. The buyers in this case would be wholesalers or refiners.

In event of a deal taking place, the goods and the money would be exchanged directly between the buyer and the seller. Thus, it can be seen that this market is restricted to only those people who are directly involved with the commodity.

In addition to the spot transactions, forward deals also take place in these markets. However, they too happen on a delivery basis and hence are restricted to the participants in the spot markets.

7. WHAT ARE THE CHARACTERISTICS OF THE EXCHANGE TRADED MARKETS?

The exchange-traded markets are essentially only derivative markets and are similar to equity derivatives in their working. That is, everything is standardised and a person can purchase a contract by paying only a percentage of the contract value. A person can also go short on these exchanges.

Also, even though there is a provision for delivery most of the contracts are squared-off before expiry and are settled in cash. As a result, one can see an active participation by people who are not associated with the commodity.

8. DO THE COMMODITY EXCHANGES FACILITATE DELIVERY?

The commodity exchanges do facilitate delivery, although it has been observed world-over that only 2 per cent of all the trades result in actual delivery.

9. WHY IS THE PERCENTAGE OF DELIVERY RATIO VERY LOW IN THE EXCHANGE-BASED COMMODITY DERIVATIVES?

Many people who participate in the exchanges are those who are not involved with the physical trading of the commodity. Thus, they would not like receiving delivery and would not be in a position to give delivery.

Standardised contracts make an unfeasible proposition for any trader to give or take delivery. E.g. if the size of 1 soya contract is 10 MT, a trader cannot buy/ sell 15 MT of soya through the exchange. Also, one cannot avail a credit facility in the exchanges that may be available in the local market. These and other factors deter a person from giving/ receiving delivery through the exchanges.

10. WHAT IS THE SIZE OF THE COMMODITIES MARKET AS COMPARED TO THE EQUITY MARKET?

In the developed markets the volumes on the exchange-based commodity derivates markets are about five times more than that of the equity markets.

11. WHAT IS THE HISTORY OF COMMODITIES MARKETS IN INDIA?

India, being an agro-based economy, has markets for most of the agro-based commodities. India is the largest consumer of gold in the world, which

implies a huge market for the yellow metal. India has huge spot markets for all these commodities. For instance, Indore has a huge market for soya, Ahmedabad for castor seeds and Surendranagar for cotton, etc.

During the pre-Independence era, India also had a thriving futures market for commodities such as gold, silver, cotton, edible oils, etc. In mid-1960s, due to wars, natural calamities and the consequent shortages, futures trading in most commodities was banned.

Currently, the futures markets that exist in India are localised for specific commodities. For example, Kerala has an exchange for pepper; Ahmedabad for castor seeds, and Mumbai is the major Centre for gold, etc. These exchanges, however, have only a regional presence and are dominated by people who are involved with the physical trade of that commodity.

12. WHAT ARE THE CURRENT DEVELOPMENTS IN THIS MARKET?

The government has allowed national commodity exchanges, similar to the Bombay Stock Exchange and the National Stock Exchange, to come up and let them deal in commodity derivatives in an electronic trading environment. These exchanges are offering a nation-wide anonymous, order-driven, screen-based trading system for trading. Earlier the Forward Markets Commission (FMC) was regulating these exchanges, however, post NSEL scam, regulation of commodity exchanges has come to SEBI fold.

Initially four commodity exchanges as under had been approved to commence business in this regard but now both NSE and BSE are also allowed commodity derivatives business.

- Multi Commodity Exchange of India Ltd (MCX), located at Mumbai
- National Commodity and Derivatives Exchange Ltd (NCDEX), located at Mumbai
- National Board of Trade (NBOT), located at Indore
- National Multi Commodity Exchange (NMCE), located at Ahmedabad.

13. WHAT IS THE NEED FOR THE EXCHANGE-TRADED COMMODITY DERIVATIVES MARKET?

The biggest advantage of having an exchange-based platform is reach. A wider reach ensures greater participation, which results into a more efficient price discovery mechanism. In fact, it comes to a stage where the derivative market guides the spot market in terms of pricing. This can be well understood by looking at the following example:

Imagine a soy wholesaler in Madhya Pradesh, who -- having bought the crop from the farmer -- wishes to sell it to the oil refiners. To sell his crop he has to go to the local market at Indore.

The price that he will get for his crop would be solely dependent upon the demand supply condition prevailing at that point of time at that market place. Also as the number of players is less there are chances of the prices being biased. In contrast the prices in the futures market are determined not only by the local demand supply conditions but also by the global scenario.

Add to that the view taken on a commodity by various sets of people depending upon different parameters such as technical analysis, political news, exchange rates, etc. The price that is thus quoted can be safely regarded as the most efficient price.

Thus, looking at the futures price the trader can price his crop appropriately.

14. WHAT OPPORTUNITIES DO THE COMMODITY DERIVATIVES PROVIDE FOR INVESTORS?

Futures contract in the commodities market, similar to equity derivatives segment, will

facilitate the activities of speculation, hedging and arbitrage to all class of investors.

14.1 Speculation: It facilitates speculation by providing opportunity to people, although not involved with the commodity, to trade on the views in the movement of commodity prices. The speculative position is taken with a small margin amount that is paid to the exchange, and the contract can be squared-off anytime during the trading hours.

14.2 Hedging: For the people associated with the commodities the futures market can provide an effective hedging mechanism against price movements.

For example, an oil-seed farmer may go short in oil-seed futures, thus 'locking' his sale price and in the process hedging against any adverse price movements.

On the other hand, a processor of oil seeds may buy oil-seed futures and thus assure him a supply of oil-seeds at a pre-determined price. Similarly, the oil-seed processor may go short in oil futures, which may be bought by a wholesaler of oil.

Also, there is a saying that 'gold shines when everything fails.' Thus, gold can be used as a hedging tool against other investments.

14.3 Arbitrage: Traders may exploit arbitrage opportunities that arise on account of different prices between the two exchanges or between different maturities in the same underlying.

15. TAX TREATMENT

Filing of Income-tax returns with regards to any income earned from the trading in Futures and Options is by and large confusing for most taxpayers. Most Futures and Options transactions are quite huge and take place on a regular basis with low profits generated. Due to the high number of transactions taking place for large amounts, the levying of income-tax on the profit or loss obtained via these transactions is treated differently as compared to the profit or loss arising out of any other form of business. Keeping this in mind, income arising from the trading of Futures and Options could be treated either as business income or as capital gains.

15.1 Provisions of Section 43(5): Section 43(5) of the Income-tax Act states that any transactions that take place from Futures and Options trading on recognised exchange with payment of CTT are deemed to be non-speculative transactions. This means that any profits earned from such trading would be taxed in the same manner as income or profits acquired from the carrying on of any other kind of business.

15.2 Ramifications of Treating Income from Futures and Options as Business Income

Should any income or profits arising from the trading of Futures and Options be treated as business income then the following ramifications come into play:

- Any expenditure relating to administration is considered to be deductible.
- Any loss arising from trading of Futures and Options can be offset against any income arising from the taxpayer's residential property, any other business as well as any other source barring the taxpayer's regular salary.
- Any losses that have not been absorbed can be offset against any income the taxpayer receives from any other business, and can be carried forward for a maximum period of 8 years.
- A tax audit will be mandatory if the turnover or income arising from trading of Futures and Options is above and beyond Rs. 1 crore.

15.3 Ramifications of Treating Income from Futures and Options as Capital Gains

Should any income or profits arising from the trading of Futures and Options be treated as capital gains then the following ramifications come into play:

- Any income will be considered to be short-term income or profit and will be taxed according to regular income-tax slab rates.
- Any loss will be treated as short term capital loss, which can be offset against any capital gains acquired by the taxpayer through other sources. This loss can be carried ahead for a maximum period of 8 years

15.4 How is Turnover Determined with Regards to Futures and Options?

In order to determine the total turnover derived from the trading of Futures and Options, it is necessary to take into consideration the following factors:

- The sum total of any favourable trades as well as unfavourable trades.
- Any premium that has been obtained following the sale of options is also to be considered.
- Any difference arising in relation to any reverse trades that may have been entered into.

It is important to determine turnover in order to conduct tax audit on the final amount as per Section 44AB of the Income-tax Act, 1961. Tax audits, however, are only applicable in instances where the total turnover determined over the course of a fiscal year is more than Rs. 1 crore.

16. CASE STUDY 1

16.1 Tax Evasion by Brokers & Clients

16.1.1 Case Brief

Manipulation by brokers in commodity transaction–All India searches on brokers and commodity exchanges–Client code modification–Proprietary trading to accommodate entries.

16.1.2 Pre-Search Inquiry

Rules and regulations of Forward Market Commission, commodity Exchanges and Forward Contracts (Regulation) Act (FCRA). Intelligence was gathered about the modes of tax-evasion adopted by the brokers and their clients and the names of the main brokers indulging in such practices. Information of tax evasion in Ahmedabad, Jalgaon, Bangalore, Chennai, New Delhi, Bikaner, Jodhpur, Hisar and Indore was shared.

16.2 *Modus Operandi* of Tax Evasion Client Code Modifications

16.2.1 Search Operation

The exchanges were asked to furnish the details of all trades where the client codes had been changed by the brokers.

- Exchanges submitted a list of about 30 lakh trades which contained the details such as original client code, modified client code, trade number, order number, original trade time, modified trade time, trading contract, quantity, price etc.
- When this data was analyzed a definite pattern emerged showing that in respect of a few brokers there were a large number of client code modifications. These cases were taken up for further investigation.

- During the course of investigations many brokers conceded that such client code modifications were not genuine and that the changes were made with a view to avoid taxation of the profits.

The searches carried out at Ahmedabad, Jalgaon, Bangalore, Chennai, New Delhi, Bikaner, Jodhpur, Hisar and Indore resulted in admission of unaccounted income of ₹ 40 crores.

16.2.2 Allied Information

Market information also was received that in the commodities futures market, there are many commodities in which negligible number of trades take place and hence are called illiquid commodities. Some of such commodities are 'IGOLDKOL' 'GOLDAHM' 'IGOLDDEL' 'STEELLGBVN', 'STEELLONG', 'STEELFLAT', 'CASHEWKERN' and 'HDPEHM'. The brokers took advantage of these illiquid commodities and entered into non-genuine synchronized transactions in these commodities with intent to transfer profit/ losses.

16.2.3 Search Analysis

During the course of the search, the trade log of the brokers was collected and analyzed. Different types of analysis were attempted by sorting the data on time, commodity and client basis. The analysis showed abnormality in the trading pattern of certain commodities. This was enquired into further and after examination of a few clients, the following *modus operandi* we noticed:

- The intraday fluctuations in the illiquid commodities were much more than other commodities.
- During the day, the party who wanted to book losses bought at 'HIGH' and sold at 'LOW' in short intervals and the other party who wanted profits or a shell party sold at 'HIGH' and bought at 'LOW'.
- At the end of the day, the transactions were squared off so that the net position for each of the parties was 'NIL'.
- After the conclusion of the transactions, the party who got the losses would suitably compensate the other party for lending its name (say a commission of 2–10%), and received back the difference in cash.

16.2.4 Final Outcome

When the above *modus operandi* was discovered in the case of a Mumbai assessee, that assessee promptly revised his return offering additional income of ₹ 80.11 lakhs and paid tax thereon.

17. CASE STUDY 2

17.1 Discrepancies in Stocks in Connivance with NSEL-Bogus Purchases and Siphoning Off of Investors' Funds

17.1.1 Case Summary

Case pertains to a Multi Agency Enquiry comparing NSEL stock details and actual stocks revealing a shortage in taxpayer's stocks. It is clear that trading on NSEL platform was on the basis of bogus purchases as confirmed during search. The investor's money was siphoned off and invested in sister concerns.

17.1.2 Assessee Details

Genex Group of Industries: A search was conducted at Ludhiana, on 23.05.2013, which brought to light a very large scam having All India ramifications with the active connivance of National Spot Exchange Ltd., Bombay (NSEL).

17.2 Highlight of the Case/ *Modus Operandi*

17.2.1 Massive Stock Mismatch Detected during Search

It was found that one of the group companies in Ludhiana, Punjab was engaged in trading in

Raw Wool and Wool Top at the NSEL platform. The designated godowns for Raw Wool by NSEL were also covered. Detailed stock taking was conducted and the stock of Raw Wool at the designated godowns of the NSEL was found to be much shorter than the quantity mentioned in the registers at the godowns as well as on the electronic platform by NSEL. The total quantity of Raw Wool was found to be 3152.61 MT whereas total quantity of stock of Raw Wool as per records maintained at the godowns was 11764 MT, and hence was short by 8611.39 MT. Further, as per the NSEL site (www.nationalspotexchange.com), as on 23.05.2013, the total stock of Raw Wool was mentioned as 12154 MT. Again, as per the records at the godowns and as also confirmed by the Warehousing Supervisor present, the quantity of Raw Wool was stated to be 11764 MT, as also confirmed by AVP Ware Housing Department, NSEL on 28-05-2013. The company in Ludhiana was the only entity who had been trading in Raw Wool stock on NSEL in the whole of India.

17.2.2 NSEL Questioned

NSEL was questioned on the above. It stated that the stock of Raw Wool deposited in the two godowns of Ludhiana company was 17397 MT. However, no explanation was given regarding the discrepancy in stock mentioned on the internet and as per their records. Interestingly, there was a report of an Insurance Surveyor, on behalf of National Insurance Company Ltd., as per which the two godowns do not allow for keeping that much huge stock.

17.2.3 Discrepancies in Both Quantity and Quality

It was not only the quantity of the stock which varied, even the quality of the stock was not same, which was shown to be traded on the NSEL platform. 40 samples were taken from the stock and the same were got tested from the laboratory of Textiles, functioning under the Ministry of Textiles, Govt. of India, at Ludhiana. The relevant test report showed that the stock was of very inferior quality than what was being traded on the NSEL Trading platform.

17.2.4 Misuse of T = 26 Settlement Day Cycle and Transfer of Funds to Group Companies

It was clear that company in Ludhiana was trading on electronics platform of NSEL and giving a rosy picture of the stock of Raw Wool for trading through NSEL. It took advantage of the trading cycles of T+26 days in which it could sell the same stock of Raw Wool to a number of investors and generate huge funds. These funds were then transferred to the other group concerns from where they were further transferred to other group concerns.

17.2.5 Bogus Purchases Booked with the Help of Entry Providers

The company was also found to be engaged in the booking of bogus purchases, as confirmed from their bank accounts, as the payments were being made through RTGS which were immediately withdrawn in cash. In some cases, the entry provider accepted that he allowed his bank account to be operated by the Group for depositing the money in the form of RTGS and withdrawing in cash for example, it was found that in all the bank accounts the introducer is one of the promoter Directors of company in Ludhiana. Bank account statements of these accounts reveal the same pattern of credit and debit entries.

17.2.6 Highly Overstated Stock for Insurance Purpose

It also emerged that the stock of Raw Wool was insured by National Insurance Company Ltd. for a sum of ₹ 1300 crore for the period

February, 2013 to February, 2014. However, on conducting an inspection by the Surveyor, appointed by National Insurance Company Ltd., it was found that the stock of Raw Wool was highly overstated. National Insurance Company Ltd. therefore cancelled the Insurance Policy of company in Ludhiana taken for the stock of Raw Wool. However, in the month of June, 2013, the stock of Raw Wool was insured by NSEL from New India Insurance Company Ltd., Mumbai (NIA) against fire and theft for a sum insured of ₹1010 crore. On enquiry, NIA submitted that the Insurance Policy has been issued on the basis of the declaration and proposal form submitted by the insured and that too for stocks of Grain, Oil Seed, Jute and Cotton, whereas till the date of search there was only Raw Wool lying in the two designated godowns. This irregularity noticed in the Insurance of the stock of Raw Wool has been brought to notice of IRDA.

17.2.7 Siphoning Off Funds to Sister Concerns Via Equity Investments or Unsecured Loans

As regards the flow of money it was found that in the trading through the electronic platform of NSEL, the money of the investors was received through NSEL into the settlement account of company in Ludhiana maintained with HDFC Bank Ltd. On examination it was found that the quantum of money received by other company during the period April, 2012 to February, 2013, the total amount received came to ₹ 245.20 crore. The total amount received was ₹ 193.11 crore during the period April, 2012 till May, 2013. The Director promoters of company in Ludhiana and other sister concerns had siphoned off the investor's money in a very systematic manner and were investing the same in purchase of Real Assets or share capital in the sister concerns, as well as showing unsecured loans.

17.3 Misuse of NSEL Platform with Connivance of NSEL

1. The trading in NSEL is a physical delivery-based trading in which the seller has to physically deliver the commodities offered by him for trading through NSEL.
2. The seller has to deposit the commodities at the designated warehouses.
3. There is a settlement cycle for the commodities traded through NSEL. This cycle determines the time period within which the trade has to be settled.
4. The buyer pays the money to the seller for the whole of the lot to be purchased and on the last day of the settlement cycle the traded quantity has to be delivered to the buyer.

However, in reality this does not happen. The trade is settled only by repaying the whole amount of money back to the buyer, which means the purchaser sells it back to the seller. All the financial transactions take place through NSEL. NSEL guarantees the quantity and quality of the commodity traded. But neither details of quantity of the commodity nor quality are available with NSEL. No satisfactory reply was received from them.

Follow up Action with FMC and IRDA: This search proved that investor's money was being siphoned off by the trading entity with the active connivance of NSEL Authorities. Whole system of NSEL was being exploited brazenly. All the relevant facts were brought to the notice of Forward Marketing Commission as well as to the Insurance Regulatory Authority. Similar kind of *modus operandi* was being adopted by other specified traders who were trading their stock in other agro products, especially rice, cotton, chillies etc., in the other regions of India. As soon as the investors came to know the real facts

relating to NSEL, there was a payment crisis, as the trading entities had siphoned of the funds and failed to clear the liabilities. The company in Ludhiana was one of the biggest defaulters owing more than ₹ 700 crore to the NSEL investors. An all India survey was conducted at the various trading entities of NSEL as well as the designated godowns on 22.08.2013. Economic Offences Wing, Mumbai also registered criminal cases against the NSEL authorities, who were subsequently arrested.

Final Outcome: The Regulatory Authorities have stopped the NSEL Trading.

CHAPTER

8

Money and Currency Markets in India

1. MONEY MARKET IN INDIA

1.1 Money market is the collective name given to the various firms and institutions that deal in the various grades of near money. It also refers to the market for short-term financial assets that are close substitutes of money. It is a market for short-term loans in the sense that it provides money for working capital or circulatory capital. The most important feature of a money market instrument is that it is liquid and can be turned into money quickly at a low cost and provides an avenue for equilibrating the short-term surplus funds of lenders and the requirements of borrowers. India's short-term credit market or money market consists of two sectors:

i. Organised sector comprising the Reserve Bank of India, Commercial banks, and Cooperative Banks etc.

ii. Unorganised sector comprising the money lenders, NBFCs, Chit funds, Nidhi companies etc.

2. MAJOR INSTRUMENTS IN THE INDIAN MONEY MARKET

2.1 Call and Notice Money Market: The call/ notice money market forms an important segment of the Indian Money Market. Under call money market, funds are transacted on an overnight basis and under notice money market, funds are transacted for a period between 2 days and 14 days. The Scheduled commercial banks (excluding RRBs), Co-operative banks (other than Land Development Banks) and Primary Dealers (PDs), are permitted by the RBI to participate in call/ notice money market, both as borrowers and lenders. The RBI, from time to time, has set the prudential limits in respect of both outstanding borrowing and lending transactions in call/ notice money market as well as their reporting formats vide their 'Master Direction on Money Market Instruments: Call/ Notice Money Market, Commercial Paper, Certificates of Deposit and Non-Convertible Debentures (original maturity up to one year)' last issued in F. No. RBI/ FMRD/ 2016–17/ 32 FMRD. Master Direction No. 2/ 2016–17 dated July 7, 2016. The eligible participants are free to decide on interest rates in call/ notice money market and the calculation of interest payable

is based on the methodology given in the Handbook of Market Practices brought out by the Fixed Income Money Market and Derivatives Association of India (FIMMDA).

2.2 Commercial Paper (CP): This is a short term unsecured promissory note with maturity period of 7 days to one year. Since it is unsecured, it is issued by the large and creditworthy companies to meet their short-term fund requirements. The primary dealers (PDs) and all-India financial institutions (FIs) are also permitted to issue CP to enable them to meet their short-term funding requirements. The CP is issued by the issuers at a discount to face value of CP and the face value of CP is in the denomination of Rs. 0.5 million and multiples thereof. The CP is issued at discount and redeemed at par. It is negotiable and transferable by endorsement. The funds raised through Commercial Paper can be used for fulfilling seasonal and working capital needs e.g. Bridge Financing.

2.2.1 A company is eligible to issue CP provided: (i) the tangible net worth of the company, as per the latest audited Balance Sheet, is not less than Rs. 4 crore; (ii) the company has been sanctioned working capital limit by bank/s or FIs; and (iii) the borrowal account of the company is classified as a Standard Asset by the financing bank/ institution. The eligible participants/ issuers are required to obtain credit rating for issuance of CP from any one of the SEBI registered CRAs. The minimum credit rating shall be 'A3' as per rating symbol and definition prescribed by SEBI.

2.2.2 Incidentally, the Reserve Bank of India (RBI) had designated the 'Fixed Income Money Markets and Derivatives Association (FIMMDA) and the 'Foreign Exchange Dealers' Association of India (FEDAI) as the nodal agencies to administer rupee interest rate and the foreign exchange benchmarks in the markets, in order to standardize and strengthen the benchmarks for these financial instruments. Recently, the RBI has designated Financial Benchmark India Pvt. Ltd. (FBIL) for valuation of portfolios of government securities, which earlier used to be done by FIMMDA. These bodies have their own separate offices and websites and they can be contacted by the assessing officers for any information in their respective fields.

2.2.3 The investor in CP (primary subscriber) is required to pay the discounted value of the CP to the account of the issuer through the 'Issuing and Paying Agent (IPA)' i.e. a Scheduled Bank acting as an IPA. The redemption proceeds are also received through the IPA. The Standardised procedures and documentation for CPs are as per FIMMDA, with the approval of RBI. The reporting of the trading and settlement of CP is mandated by the RBI in its Master Circular quoted above. Further the RBI has issued Reserve Bank Commercial Paper Directions, 2017 also.

2.3 Certificates of Deposit: It is a negotiable money market instrument and issued in dematerialised form or as a Usance Promissory Note against funds deposited at a bank or other eligible financial institution for a specified time period. It is issued by the scheduled commercial banks {excluding Regional Rural Banks and Local Area Banks}; and few select All-India Financial Institutions (FIs) that have been permitted by RBI to raise short-term resources.

2.4 Non-Convertible Debentures (NCDs): These have original or initial maturity period of up to one year: These are debt instruments issued by a corporate (including NBFCs) by way of private placement. The RBI has issued instructions on these too in the Master Circular referred to above.

2.5 Government Security (G-Sec) Market: A Government Security (G-Sec) is a tradeable instrument issued by the Central Government or the State Governments. It acknowledges the Government's debt obligation. Such securities are short term (usually called treasury bills, with original maturities of less than one year) or long term (usually called Government bonds

or dated securities with original maturity of one year or more). In India, the Central Government issues both, treasury bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called the State Development Loans (SDLs). G-Secs carry practically no risk of default and, hence, are called risk-free gilt-edged instruments. The money market related aspects of G-Sec are:

a. **Treasury Bill Market:** These are short term borrowing of the Central Government with maturity period of less than one year. Treasury bills are zero coupon securities and pay no interest. They are issued at a discount and redeemed at the face value at maturity. For example, a 91 day Treasury bill of ₹ 100/- (face value) may be issued at say ₹ 98.20, that is, at a discount of say, ₹ 1.80 and would be redeemed at the face value of ₹ 100/-. The return to the investors is the difference between the maturity value or the face value (that is ₹ 100) and the issue price. These are highly liquid and no risk of default of payment is there. Treasury bills are of two types: ad hoc, and regular. Ad hoc treasury bills are sold to the state governments and foreign central banks and, therefore, these are not marketable. Regular treasury bills are sold to the banks and to the public and, therefore, are freely marketable. At present the following types of treasury bill are in use:

   i. 91–day treasury bills,

   ii. 182–day treasury bills,

   iii. 364–day treasury bills.

b. **Cash Management Bills (CMBs):** In 2010, Government of India, in consultation with RBI introduced a new short-term instrument, known as Cash Management Bills (CMBs), to meet the temporary mismatches in the cash flow of the Government of India. The CMBs have the generic character of T-bills but are issued for maturities less than 91 days.

c. **Dated G-Secs:** Dated G-Secs are securities which carry a fixed or floating coupon (interest rate) which is paid on the face value, on half-yearly basis. Generally, the tenor of dated securities ranges from 5 years to 40 years. The nomenclature of a typical dated fixed coupon G-Sec contains the following information-coupon, name of the issuer, maturity year.

G-Secs are issued through auctions conducted by RBI on the electronic platform called the E-Kuber, the Core Banking Solution (CBS) platform of RBI. Commercial banks, scheduled UCBs, certain Primary Dealers, insurance companies and provident funds, who maintain funds account (current account) and securities accounts (Subsidiary General Ledger (SGL) account) with RBI, are members of this electronic platform. The non-E-Kuber members including non-scheduled UCBs can participate in the primary auction through scheduled commercial banks or PDs (called as Primary Members-PMs). For this purpose, the UCBs need to open a securities account with a bank/PD–such an account is called a Gilt Account. A Gilt Account is a dematerialized account maintained with a scheduled commercial bank or PD. The proprietary transactions in G-Secs undertaken by PMs are settled through SGL account maintained by them with RBI at PDO. The transactions in G-Secs undertaken by Gilt Account Holders (GAHs) through their PMs are settled through Constituent Subsidiary General Ledger (CSGL) account maintained by PMs with RBI at PDO for its constituent (e.g., a non-scheduled UCB). The details of all the dated securities issued by the Government of India are available at http://www.rbi.org.in/Scripts/financialmarketswatch.aspx.

2.6 Commercial/ Trade Bill Market: Trade Bill is a bill drawn by one trader on another. Traders get money by discounting such bills in a commercial bank so as to avail financial accommodation. In this market the trade bills or commercial bills are traded by the banks/ FIs but this market is not very developed in India.

2.7 Repo Market: Repurchase Options or Repo is a money market instrument which helps in collateralised short-term borrowing and lending through purchase-sale operations in debt instruments. It is used by the Central Bank and banking institutions to manage their daily/ short term liquidity. The Reserve Bank of India (RBI) Act, 1934 defines the terms 'repo' and 'reverse repo' in sub-sections (c) and (d) of Section 45 U of Chapter III D of the RBI Act. Repo means an instrument for borrowing funds by selling securities of the Central Government or a State Government or of such securities of a local authority as may be specified in this behalf by the Central Government or foreign securities, with an agreement to repurchase the said securities on a mutually agreed future date at an agreed price which includes interest for the funds borrowed. Reverse Repo means an instrument for lending funds by purchasing securities of the Central Government or a State Government or of such securities of a local authority as may be specified in this behalf by the Central Government or foreign securities, with an agreement to resell the said securities on a mutually agreed future date at an agreed price which includes interest for the funds lent.

2.7.1 Indian repo market predominantly uses sovereign securities, though repo is allowed on corporate bonds and debentures also. RBI has permitted select entities (scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs), Primary Dealers (PDs), all-India Financial Institutions, Non-Banking Financial Companies (NBFCs), mutual funds, housing finance companies, insurance companies) to undertake repo in corporate debt securities since January 2010. This is similar to repo in Government securities except that corporate debt securities are used as collateral for borrowing funds. Only listed corporate debt securities, that are rated 'AA' or above by the rating agencies, are eligible to be used for repo. Commercial papers, certificate of deposit, non-convertible debentures of original maturity less than one year are not eligible for the purpose. These transactions take place in the over the counter (OTC) market and are required to be reported on FIMMDA platform within 15 minutes of the trade for dissemination of information. They are also to be reported on the clearing house of any of the exchanges for the purpose of clearing and settlement. Based on the securities used, a narrow definition for repo and reverse repo is also provided in Sub Section 12AB of Section 17 of the RBI Act in respect of the Liquidity Adjustment Facility (LAF) conducted by the Reserve Bank of India wherein only sovereign securities (not corporate securities) are used for infusing/ sucking liquidity from the market.

2.7.2 All the Repo and Reverse Repo transactions are reported on an electronic platform called the Negotiated Dealing System (NDS). The Clearing Corporation of India Ltd. (CCIL), has put in an anonymous online repo dealing system in India, thereby moving the telephonic over-the-counter trading to an anonymous order matching electronic platform.

2.7.2 The Repo transactions have two legs. In the first, the seller sells securities and receives cash while the purchaser buys securities and parts with cash. In the second leg, securities are repurchased by the original holder. He pays to the counter party the amount originally received by him plus the return on the money for the number of days for which the money was used by him, which is mutually agreed. The duration between the two legs is called the 'repo period'. Predominantly,

repos are undertaken on overnight basis, i.e., for one day period. In the first leg of the transaction, sale price of securities is usually based on the prevailing market price for outright deals. As the ownership of securities passes on from seller to buyer for the repo period, legally the coupon interest accrued for the period has to be passed on to the buyer. Hence, in the second leg happening on the future date, the price will be structured based on the funds flow of interest and tax elements of funds exchanged. When repo rate is higher than current yield, repurchase price will be adjusted upward signifying a capital loss. If the repo rate is lower than the current yield, then the repurchase price will be adjusted downward signifying a capital gain. If the repo rate and coupon are equal, then the repurchase price will be equal to the sale price of security.

2.7.3 Whether a transaction is a repo or a reverse repo is determined only in terms of who initiated the first leg of the transaction. In other words, a transaction is called a repo when viewed from the perspective of the supplier of the securities (the party acquiring funds) and a reverse repo when described from the point of view of the supplier of funds.

2.8 Money Market Mutual Funds: This instrument was introduced in April 1992 to provide additional short-term revenue to the individual investors.

2.9 Certificate of Deposit (CD): These are time deposits like fixed deposits that are offered by scheduled commercial banks. The only difference between FD and CD is that you cannot withdraw CD before the expiry of the term.

3. SUGGESTIONS FOR ASSESSING OFFICERS

3.1 The officers should understand the respective money instruments and should consult the website of RBI for the master circulars and instructions. These can assist the officers in formulating a view on the allow ability of the expenses and the taxing of the incomes arising from the money market.

3.2 The taxability of the interest incomes has to be done under the correct head i.e. income from other sources or business income as the case may be. The parking of surplus business funds to earn interest income is required to be treated as income from other sources. The transactions should be examined from the angle of speculative or non-speculative transactions also, if required. The AO would also need to make appropriate adjustments if the settlement period spills over the close of the previous year concerned.

4. CURRENCY MARKET

4.1 Currencies are bought and sold, just like other commodities, in markets called foreign exchange markets. Currency trading is the act of buying and selling of international currencies. Besides the banks and financial institutions, the individual investors can also engage in currency trading. Their aim is to benefit from the variations in the exchange rate of the currencies.

4.2 Foreign exchange market is described as an OTC (Over the counter) market as there is no physical place where the participants meet to execute their deals. It is more an informal arrangement among the banks and brokers operating in a financing centre purchasing and selling currencies, connected to each other by tele-communications like telex, telephone and satellite communication network. The term foreign exchange market is used to refer to the wholesale segment of the market, where the dealings take place among the banks. The retail segment refers to the dealings take place between banks and their customers.

4.3 The International forex market is the biggest and the fastest growing market in the world economy with a daily turnover of over USD 4 trillion. The forex markets were primarily developed to facilitate settlement of debts arising out of international trade. The largest foreign

exchange market is London followed by New York, Tokyo, Zurich and Frankfurt. The markets are situated throughout the different time zones of the globe in such a way that when one market is closing the other is beginning its operations. Thus, at any point of time one market or the other is open. Therefore, it is often said that foreign exchange market is functioning 24 hours of the day. (Though, a specific market will function only during the business hours). In India, the market is open for the time the banks are open for their regular banking business. No transactions take place on Saturdays.

5. INTERBANK MARKETS

The exchange rates quoted by banks to their customer are based on the rates prevalent in the interbank market. Besides the Interest rates, the interbank rate also refers to the price at which banks conduct wholesale foreign exchange transactions in both the spot and forward market with the spreads being tighter than for smaller retail transactions. The big banks in the market are known as market makers, as they are willing to buy or sell foreign currencies at the rates quoted by them up to any extent. Typically, the quotation in the interbank market is a two-way quotation. It means the rate quoted by the market maker will indicate two prices. One at which it is willing to buy the foreign currency, and the other at which it is willing to sell the foreign currency.

6. KEY TERMS IN CURRENCY MARKETS

6.1 Spot and Forward Transactions

The transactions in the interbank market may be settled:

a. On the same day; or

b. Two days later; or

c. Some days late; say after a month

Where the agreement to buy and sell is agreed upon and executed on the same date, the transaction is known as cash or ready transaction. It is also known as value today. The transaction where the exchange of currencies takes place two days after the date of the contact is known as the spot transaction. For instance, if the contract is made on Monday, the delivery should take place on Wednesday. If Wednesday is a holiday, the delivery will take place on the next day, i.e., Thursday. Rupee payment is also made on the same day the foreign currency is received.

The transaction in which the exchange of currencies takes places at a specified future date, subsequent to the spot date, is known as a forward transaction. The forward transaction can be for delivery one month or two months or three months etc. A forward contract for delivery one month means the exchange of currencies will take place after one month from the date of contract. A forward contract for delivery two months means the exchange of currencies will take place after two months and so on.

6.2 Forward Margin/ Swap Points

It is possible that the Forward rate may be the same as the spot rate for the currency. Then it is said to be 'at par' with the spot rate. More often the forward rate for a currency may be costlier or cheaper than its spot rate. The difference between the forward rate and the spot rate is known as the 'forward margin' or swap points. The forward margin may be either at 'premium' or at 'discount'. If the forward margin is at premium, the foreign correct will be costlier under forward rate than under the spot rate. If the forward margin is at discount, the foreign currency will be cheaper for forward delivery then for spot delivery. Under direct quotation, premium is added to spot rate to arrive at the forward rate. This is done for both purchase and sale transactions. Discount is deducted from the spot rate to arrive at the forward rate.

6.3 Basis

Basis can be defined as the futures price minus the spot price. In a normal market, basis will be positive. Futures prices normally exceed spot prices.

6.4 Futures

While a future contract is similar to a forward contract, there are several differences between them. While a forward contract is tailor made for the client by his international bank, a future contract has standardized features and the contract size and maturity dates are standardized. Futures can be traded only on an organized exchange and they are traded competitively. Margins are not required in respect of a forward contract but margins are required of all participants in the futures market an initial margin must be deposited into a collateral account to establish a futures position.

6.5 Options

An option is a contract or financial instrument that gives holder the right to sell or buy a given quantity of an asset as a specified price at a specified future date. An option to buy the underlying asset is known as a call option and an option to sell the underlying asset is known as a put option. Buying or selling the underlying asset via the option is known as exercising the option. The stated price paid (or received) is known as the exercise or striking price. The buyer of an option is known as the long and the seller of an option is known as the writer of the option, or the short. The price for the option is known as premium.

6.6 Swap Operation

Commercial banks who conduct forward exchange business may resort to a swap operation to adjust their fund position. The term swap means simultaneous sale of spot currency for the forward purchase of the same currency or the purchase of spot for the forward sale of the same currency. The spot is swapped against forward. Operations consisting of a simultaneous sale or purchase of spot currency accompanies by a purchase or sale, respectively of the same currency for forward delivery are technically known as swaps or double deals as the spot currency is swapped against forward.

6.7 Arbitrage

Arbitrage is the simultaneous buying and selling of foreign currencies with intention of making profits from the difference between the exchange rate prevailing at the same time in different markets.

6.8 Exchange Rate

The exchange rate is a price-the number of units of one nation's currency that must be surrendered in order to acquire one unit of another nation's currency.

6.9 Contract Cycle

The currency futures contracts on the SEBI recognised exchanges have one-month, two-month, and three-month up to twelve-month expiry cycles. Hence, these exchanges will have 12 contracts outstanding at any given point in time.

6.10 Final settlement date

The last business day of the month is termed the Value date/ Final Settlement date of each contract.

6.11 Expiry Date

It is the date specified in the futures contract. All contracts expire on the last working day (excluding Saturdays) of the contract months.

The last day for the trading of the contract shall be two working days prior to the final settlement date or value date.

6.12 Contract Size

In the case of USD/ INR it is USD 1000; EUR/ INR it is EUR 1000; GBP/ INR it is GBP 1000 and in case of JPY/ INR it is JPY 100,000. (Ref. RBI Circular: RBI/ 2009–10/ 290, dated 19th January, 2010 by which RBI has allowed trade in EUR/ INR, JPY/ INR and GBP/ INR pairs.)

6.13 Cost of Carry

The relationship between futures prices and spot prices can be summarized in terms of what is known as the cost of carry. This is a measure (in commodity markets) of the storage cost plus the interest that is paid to finance or 'carry' the asset till delivery less the income earned on the asset. For currency derivatives, carry cost is the rate of interest.

6.14 Initial Margin

The amount that must be deposited in the margin account at the time a futures contract is first entered into is known as initial margin.

6.15 Marking-to-Market

In the futures market, at the end of each trading day, the margin account is adjusted to reflect the investor's gain or loss depending upon the futures closing price which is known as marking-to-market.

6.16 Foreign Exchange Deal

A forex deal is always done in currency pairs, for example, US Dollar-Indian Rupee contract (USD–INR); British Pound-INR (GBP-INR), Japanese Yen-U.S. Dollar (JPYUSD), U.S. Dollar-Swiss Franc (USD-CHF) etc.

7. FACTORS DETERMINING SPOT EXCHANGE RATES

7.1 Balance of Payments

Balance of Payments represents the demand for and supply of foreign exchange which ultimately determine the value of the currency. Exports, both visible and invisible, represent the supply side for foreign exchange. Imports, visible and invisible, create demand for foreign exchange. Put differently, export from the country creates demand for the currency of the country in the foreign exchange market. The exporters would offer to the market the foreign currencies they have acquired and demand in exchange the local currency. Conversely, imports into the country will increase the supply of the currency of the country in the foreign exchange market. When the balance of payments of a country is continuously at deficit, it implies that the demand for the currency of the country is lesser than its supply. Therefore, its value in the market declines. If the balance of payments is surplus continuously it shows that the demand for the currency in the exchange market is higher than its supply therefore the currency gains in value.

7.2 Inflation

Inflation in the country would increase the domestic prices of the commodities. With increase in prices exports may dwindle because the price may not be competitive. With the decrease in exports the demand for the currency would also decline; this in turn would result in the decline of external value of the currency.

7.3 Interest Rate

The interest rate has a great influence on the short–term movement of capital. When the interest rate at a centre rises, it attracts short term funds from other centres. This would increase the demand for the currency at the centre and

hence its value. Rising of interest rate may be adopted by a country due to tight money conditions or as a deliberate attempt to attract foreign investment. Whatever be the intention, the effect of an increase in interest rate is to strengthen the currency of the country through larger inflow of investment and reduction in the outflow of investments by the residents of the country.

7.4 Money Supply

An increase in money supply in the country will affect the exchange rate through causing inflation in the country. It can also affect the exchange rate directly. An increase in money supply in the country relative to its demand will lead to large scale spending on foreign goods and purchase of foreign investments. Thus the supply of the currency in the foreign exchange markets is increased and its value declines. The downward pressure on the external value of the currency then increases the cost of imports and so adds to inflation. The effect of money supply on exchange rate directly is more immediate than its effect through inflation. While in the long run inflation seems to correlate exchange rate variations in a better way, in the short run exchange rates move more in sympathy with changes in money supply. One explanation of how changes in money supply vary the exchange rate is this; the total money supply in the country represents the value of total commodities and services in the country. Based on this the outside world determines the external value of the currency. Another explanation offered is that the excess money supply flows out of the country and directly exerts a pressure on the exchange rate. The excess money created, the extent they are in excess of the domestic demand for money, will flow out of the country. This will increase the supply of the currency and pull down its exchange rate.

7.5 National Income

An increase in national income reflects increase in the income of the residents of the country. This increase in the income increases the demand for goods in the country. If there is under travelling production capacity in the country, this will lead to increase in production. There is a chance for growth in exports too. But more often it takes time for the production to adjust to the increased income. Where the production does not increase in sympathy with income rise, it leads to increased imports and increased supply of the currency of the country in the foreign exchange market. The result is similar to that of inflation, *viz.*, and decline in the value of the currency.

7.6 Resource Discoveries

When the country is able to discover key resources, its currency gains in value e.g. oil discoveries.

7.7 Capital Movements

There are many factors that influence movement of capital from one country to another. Short term movement of capital may be influenced by the offer of higher interest in a country. If interest rate in a country rises due to increase in bank rate or otherwise, there will be a flow of short term funds into the country and the exchange rate of the currency will rise. Reverse will happen in case of fall in interest rates. Bright investment climate and political stability may encourage portfolio investments in the country. This leads to higher demand for the currency and upward trend in its rate. Poor economic outlook may mean repatriation of the investments leading to decreased demand and lower exchange value for the currency of the country. Movement of capital is also caused by external borrowing and assistance. Large scale external borrowing will increase the supply of foreign exchange in the market. This will have a favorable effect on the exchange rate of the currency of the country.

When repatriation of principal and interest starts the rate may be adversely affected.

7.8 Political Factors

Political stability induces confidence in the investors and encourages capital inflow into the country. This has the effect of strengthening the currency of the country. On the other hand, where the political situation in the country is unstable, it makes the investors withdraw their investments. The outflow of capital from the country would weaken the currency.

8. FAQs

8.1 Who can Trade in Currency Futures Markets in India?

Any resident Indian or company including banks and financial institutions can participate in the futures market. However, at present, Foreign Institutional Investors (FIIs) and Non-Resident Indians (NRIs) are not permitted to participate in currency futures market.

8.2 Which Currency Pairs are Listed in India

Any currency can be traded on the international level. However, on the Multi Commodity Exchange (MCX-SX), only 4 major currencies are traded against the Indian Rupee.

USDINR

EURINR

GBPINR

JPYINR

Options trading on USDINR is also done.

8.3 Which are the Currency Exchanges Used?

The commonly used exchanges on the national level are-Multi Commodity Exchange (MCX-SX) and National Stock Exchange (NSE). The most commonly used exchange on the international level is-COMEX

8.4 Who are the Regulators of the Market?

The currency market is regulated jointly by the Reserve Bank of India (RBI) and Securities & Exchange Board of India (SEBI).

8.5 What is Margin?

Margin is a performance bond that insures against trading losses. Margin requirements in the FX marketplace allow you to hold positions much larger than the asset value of your account. Trading with Forex Capital Management includes a pre-trade check for margin availability; the trade is executed only if there are sufficient margin funds in your account. The Forex Capital Management trading system calculates cash on hand necessary to cover current positions, and provides this information to you in real time. If funds in your account fall below margin requirements, the system will close all open positions. This prevents your account from falling below your available equity, which is a key protection in this volatile, fast moving marketplace.

8.6 What are "Short" and "Long" Positions?

Short positions are taken when a trader sells currency in anticipation of a downturn in price. Making this move allows the investor to benefit from a decline. Long positions are taken when a trader buys a currency at a low price in anticipation of selling it later for more. Making these moves allows the investor to benefit from changing market prices. Remember! Since currencies are traded in pairs, every forex position inevitably requires the investor to go short in one currency and long in the other.

9. MECHANISM OF CURRENCY MARKET

9.1 In currency trading, the lot size is usually fixed at 1000 for the currency pairs. The tick size is also fixed at 0.0025 INR or 0.25 paisa, which means that an upward tick would lead to a gain of 2.50 rupees and a downward tick would lead to a loss of 2.50 rupees (Price movement = lot size * tick size). On top of it, the broker charges between 3 to 5% as margin amount which is based on the lot size and the settlement price of the currency. The calculation of the margin is based on a formula (current price of the currency pair * lot size * 3%). Therefore, in the case of one lot of USDINR, the margin amount needed to buy one contract would be Rs. 2100/- assuming the USD rate of Rs. 70/-. (70*1000*0.03).

9.2 To demonstrate how a move of one tick affects the price; imagine a trader buys a contract (USD 1000 being the value of each contract) at Rs. 72.2500. One tick move on this contract will translate to Rs. 72.2525 depending on the direction of market movement.

Purchase price: Rs. 72.2500

Price increases by one tick: + Rs. 00.0025

New price: Rs. 72.2525

Purchase price: Rs. 72.2500

Price decreases by one tick: Rs. 00.0025

New price: Rs. 72.2475

The value of one tick on each contract is Rupees 2.50. So if a trader buys 5 contracts and the price moves up by 4 ticks, she makes Rupees 50.

Step 1: 72.2600–72.2500

Step 2: 4 ticks * 5 contracts = 20 points

Step 3: 20 points * Rs. 2.5 per tick = Rs. 50

Note: The above examples do not include transaction fees and any other fees, which are essential for calculating final profit and loss

10. RBI's CIRCULAR ON FOREIGN EXCHANGE REMITTANCES

It is required to be kept in view that the RBI controls the amount of foreign exchange that can be remitted outside the country. The master circulars of the RBI are available on the concerned website and they would need to be kept in view. Presently under the Liberalised Remittance Scheme of the RBI, all resident individuals, including minors, are allowed to freely remit up to USD 2,50,000 per financial year (April–March) for any permissible current or capital account transaction or a combination of both. The Scheme does not allow the remittance facility for the following:

i. Remittance for any purpose specifically prohibited under Schedule-I (like purchase of lottery tickets/ sweep stakes, proscribed magazines, etc.) or any item restricted under Schedule II of Foreign Exchange Management (Current Account Transactions) Rules, 2000.

ii. Remittance from India for margins or margin calls to overseas exchanges/ overseas counterparty.

iii. Remittances for purchase of FCCBs issued by Indian companies in the overseas secondary market.

iv. Remittance for trading in foreign exchange abroad.

v. Capital account remittances, directly or indirectly, to countries identified by the Financial Action Task Force (FATF) as "non-cooperative countries and territories", from time to time.

vi. Remittances directly or indirectly to those individuals and entities identified as posing significant risk of committing acts of terrorism as advised separately by the Reserve Bank to the banks.

Individuals can avail of foreign exchange facility for the following purposes within the LRS limit of USD 2,50,000 on financial year basis:

i. Private visits to any country (except Nepal and Bhutan)
ii. Gift or donation
iii. Going abroad for employment
iv. Emigration
v. Maintenance of close relatives abroad
vi. Travel for business, or attending a conference or specialised training or for meeting expenses for meeting medical expenses, or check-up abroad, or for accompanying as attendant to a patient going abroad for medical treatment/ check-up
vii. Expenses in connection with medical treatment abroad
viii. Studies abroad
ix. Any other current account transaction which is not covered under the definition of current account in FEMA 1999.

Source: RBI Circulars

CHAPTER

9

Derivatives: Futures and Options

1. Derivatives, Such as Futures or Options, are financial contracts which derive their value from a spot price, which is called the "underlying". For example, wheat farmers may wish to enter into a contract to sell their harvest at a future date to eliminate the risk of a change in prices by that date. Such a transaction would take place through a forward or futures market. This market is the "derivatives market", and the prices of this market would be driven by the spot market price of wheat which is the "underlying". The term "contracts" is often applied to denote the specific traded instrument, whether it is a derivative contract in wheat, gold or equity shares. The world over, derivatives are a key part of the financial system. The most important contract types are futures and options, and the most important underlying markets are equity, treasury bills, commodities, foreign exchange, real estate etc.

2. In a forward contract, two parties agree to do a trade at some future date, at a stated price and quantity. No money changes hands at the time the deal is signed. Forward contracting is very valuable in hedging and speculation. The classic hedging application would be that of a wheat farmer forward-selling his harvest at a known price in order to eliminate price risk. Conversely, a bread factory may want to buy bread forward in order to assist production planning without the risk of price fluctuations. If a speculator has information or analysis which forecasts an upturn in a price, then he can go long on the forward market instead of the cash market. The speculator would go long on the forward, wait for the price to rise, and then take a reversing Derivatives Trading.

2.1 Forward markets worldwide are afflicted by several problems, *viz.*:

a. Lack of centralisation of trading,

b. Illiquidity, and

c. Counterparty risk.

In the first two of these, the basic problem is that of too much flexibility and generality. The forward market is like the real estate market in that any two persons can form contracts against each

other. This often makes them design terms of the deal which are very convenient in that specific situation for the specific parties, but makes the contracts non-tradeable if more participants are involved. Also the "phone market" here is unlike the centralisation of price discovery that is obtained on an exchange, resulting in an illiquid market place for forward markets. Counterparty risk in forward markets is a simple idea: when one of the two sides of the transaction chooses to declare bankruptcy, the other suffers. Forward markets have one basic issue: the larger the time period over which the forward contract is open, the larger are the potential price movements, and hence the larger is the counter-party risk. Even when forward markets trade standardized contracts, and hence avoid the problem of illiquidity, the counterparty risk remains a very real problem.

3. Futures markets were designed to solve all the three problems of forward markets. Futures markets are exactly like forward markets in terms of basic economics. However, contracts are standardised and trading is centralized (on a stock exchange). There is no counterparty risk (thanks to the institution of a clearing corporation which becomes counterparty to both sides of each transaction and guarantees the trade). In futures markets, unlike in forward markets, increasing the time to expiration does not increase the counter party risk. Futures markets are highly liquid as compared to the forward markets.

4. Derivatives Instruments: There are two types of derivatives instruments traded on NSE and BSE; namely Futures and Options.

4.1 Futures: A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures and options contracts are traded on Indices and on Single stocks. The derivatives trading at NSE commenced with futures on the Nifty 50 in June 2000. Subsequently, various other products were introduced and presently futures and options contracts on the following products are available at NSE:

1. Indices: Nifty 50, CNX IT Index, Bank Nifty Index, CNX Nifty Junior, CNX 100, Nifty Midcap 50, Mini Nifty and Long dated Options contracts on Nifty 50.
2. Single stocks-228

4.2 Futures trading will be of interest to those who wish to:

1. Invest: Take a view on the market and buy or sell accordingly.
2. Price Risk Transfer-Hedging: Hedging is buying and selling futures contracts to offset the risks of changing underlying market prices. Thus it helps in reducing the risk associated with exposures in underlying market by taking a counter-positions in the futures market. For example, an investor who has purchased a portfolio of stocks may have a fear of adverse market conditions in future which may reduce the value of his portfolio. He can hedge against this risk by shorting the index which is correlated with his portfolio, say the Nifty 50. In case the markets fall, he would make a profit by squaring off his short Nifty 50 position. This profit would compensate for the loss he suffers in his portfolio as a result of the fall in the markets.
3. Leverage: Since the investor is required to pay a small fraction of the value of the total contract as margins, trading in Futures is a leveraged activity since the investor is able to control the total value of the contract with a relatively small amount of margin. Thus the Leverage enables the traders to make a larger profit (or loss) with a comparatively small amount of capital.

4.3 Options are contracts between two parties to purchase or sale stocks or any other asset on a future date. These are also exchange traded like Futures but the basic difference is that buyer

of the option gets right without any obligation to buy or sale the underlying asset and seller of the Option has obligation without any right. For getting such right without obligation buyer pays premium to Option seller which is known as Option premium. Like Futures, Options are also available on stock Indexes and single stocks in both BSE and NSE. Options are-Call options (right to buy) and Put Options (right to sell).

4.4 Option trading will be of interest to those who wish to:

1. Participate in the market without trading or holding a large quantity of stock.
2. Protect their portfolio by paying small premium amount.

4.5 Benefits of trading in Futures and Options:

1. Able to transfer the risk to the person who is willing to accept them.
2. Incentive to make profits with minimal amount of risk capital.
3. Lower transaction costs.
4. Provides liquidity, enables price discovery in underlying market.
5. Derivatives market are lead economic indicators.

4.6 An investor can trade the 'entire stock market' by buying index futures instead of buying individual securities with the efficiency of a mutual fund. The advantages of trading in Index Futures are:

- The contracts are highly liquid
- Index Futures provide higher leverage than any other stocks
- It requires low initial capital requirement
- t has lower risk than buying and holding stocks
- It is just as easy to trade the short side as the long side
- Only have to study one index instead of 100s of stocks

5. Trading: Futures/ Options contracts in both index as well as stocks can be bought and sold through the trading members of NSE. Some of the trading members also provide the internet facility to trade in the futures and options market. Investor clients are required to open an account with one of the trading members and complete the related formalities which include Derivatives Trading by signing of member-constituent agreement, Know Your Client (KYC) form and risk disclosure document. The trading member will allot to investor client an unique client identification number. To begin trading, client must deposit cash and/ or other collaterals with the trading member as may be stipulated by him. Futures and Options contracts expire on the last Thursday of the expiry month. If the last Thursday is a trading holiday, the contracts expire on the previous trading day.

5.1 Futures and Options contracts have a maximum of 3-month trading cycle-the near month (one), the next month (two) and the far month (three), except for the Long dated Options contracts. New contracts are introduced on the trading day following the expiry of the near month contracts. The new contracts are introduced for three month duration. This way, at any point in time, there will be 3 contracts available for trading in the market (for each security) i.e., one near month, one mid month and one far month duration respectively. For example on September 26, 2018 there would be three month contracts i.e. Contracts expiring on September 27, 2018, October 25, 2018 and November 29, 2018. On expiration date i.e September 27, 2018, new contracts having maturity of December 27, 2018 would be introduced for trading.

5.2 In-the-Money Options (ITM): An in-the-money option is an option that would lead to positive cash flow to the holder if it were exercised immediately. A Call option is said to

be in-the-money when the current price stands at a level higher than the strike price. If the Spot price is much higher than the strike price, a Call is said to be deep in-the-money option. In the case of a Put, the put is in-the-money if the Spot price is below the strike price.

5.3 At-the-money-option (ATM): An at-the money option is an option that would lead to zero cash flow if it were exercised immediately. An option on the index is said to be "at-the-money" when the current price equals the strike price.

5.4. **Out-of-the-money-option (OTM)**: An out-of-the-money Option is an option that would lead to negative cash flow if it were exercised immediately. A Call option is out-of-the-money when the current price stands at a level which is less than the strike price. If the current price is much lower than the strike price the call is said to be deep out-of-the money. In case of a Put, the Put is said to be out-of-money if current price is above the strike price.

6. Margins: are computed and collected on-line, real time on a portfolio basis at the client level. Members are required to collect the margin upfront from the client & report the same to the Exchange. 15. How are the contracts settled? All the Futures and Options contracts are settled in cash on a daily basis and at the expiry or exercise of the respective contracts as the case may be. Clients/ Trading Members are not required to hold any stock of the underlying for dealing in the Futures/ Options market. All out of the money and at the money option contracts of the near month maturity expire worthless on the expiration date.

Futures and Options-Accounting Treatment, Taxability and Levy of STT

7. ACCOUNTING FOR FUTURES

The Institute of Chartered Accountants of India (ICAI) has issued guidance note on accounting for index futures and stock futures contracts from the view point of the parties who enter into such futures contracts as buyers or sellers. For other parties involved in the trading process, like brokers, trading members, clearing members and clearing corporations, a trade in equity index futures is similar to a trade in, say shares, and does not pose any peculiar accounting problems. Hence in this Section we shall largely focus on the accounting treatment of equity index futures in the books of the client. But before doing so, a quick look at some of the terms used.

1. **Clearing Corporation/ House:** Clearing corporation/ house means the clearing corporation/ house approved by SEBI for clearing and settlement of trades on the derivatives exchange/ segment. All the clearing and settlement for trades that happen on the NSE's market is done through NSCCL.
2. **Clearing Member:** Clearing member means a member of the clearing corporation and includes all categories of clearing members as may be admitted as such by the clearing corporation to the derivatives segment.
3. **Client:** A client means a person, on whose instructions and, on whose account, the trading member enters into any contract for the purchase or sale of any contract or does any act in relation thereto.
4. **Contract Month:** Contract month means the month in which the exchange/ clearing corporation rules require a contract to be finally settled.
5. **Daily Settlement Price:** Daily settlement price is the closing price of the equity index futures contract for the day or such other price as may be decided by the clearing house from time to time.
6. **Derivative Exchange/ Segment:** Derivative exchange means an exchange approved by SEBI as a derivative exchange. Derivative segment means

segment of an existing exchange approved by SEBI as derivatives segment.

7. **Final Settlement Price:** The final settlement price is the closing price of the equity index futures contract on the last trading day of the contract or such other price as may be specified by the clearing corporation, from time to time.
8. **Long Position:** Long position in an equity index futures contract means outstanding purchase obligations in respect of the equity index futures contract at any point of time.
9. **Open Position:** Open position means the total number of equity index futures contracts that have not yet been offset and closed.
10. **Settlement Date:** Settlement date means the date on which the settlement of outstanding obligations in an equity index futures contract are required to be settled as provided in the Bye-Laws of the Derivatives exchange/ segment.
11. **Short Position:** Short position in an equity index futures contract means outstanding sell obligations in respect of an equity index futures contract at any point of time.
12. **Trading Member:** Trading member means a Member of the Derivatives exchange/ segment and registered with SEBI.

7.1 Accounting at the Inception of a Contract

Every client is required to pay to the trading member/ clearing member, the initial margin determined by the clearing corporation as per the byelaws/ regulations of the exchange for entering into equity index futures contracts. Such initial margin paid/ payable should be debited to "Initial margin-Equity index futures account". Additional margins, if any, should also be accounted for in the same manner. It may be mentioned that at the time when the contract is entered into for purchase/ sale of equity index futures, no entry is passed for recording the contract because no payment is made at that time except for the initial margin. At the Balance Sheet date, the balance in the 'Initial margin-Equity index futures account' should be shown separately under the head 'current assets'. In those cases where any amount has been paid in excess of the initial/ additional margin, the excess should be disclosed separately as a deposit under the head 'current assets'. In cases where instead of paying initial margin in cash, the client provides bank guarantees or lodges securities with the member, a disclosure should be made in the notes to the financial statements of the client.

7.2 Accounting at the Time of Daily Settlement

This involves the accounting of payment/ receipt of mark-to-market margin money. Payments made or received on account of daily settlement by the client would be credited/ debited to the bank account and the corresponding debit or credit for the same should be made to an account titled as "Mark-to-market margin-Equity index futures account".

Sometimes the client may deposit a lump sum amount with the broker/ trading member in respect of mark-to-market margin money instead of receiving/ paying mark-to-market margin money on daily basis. The amount so paid is in the nature of a deposit and should be debited to an appropriate account, say, "Deposit for mark-to-market margin account". The amount of "mark-to-market margin" received/ paid from such account should be credited/ debited to "Mark-to-market margin-Equity index futures account" with a corresponding debit/ credit to "Deposit for mark-to-market margin account". At the year-end, any balance in the "Deposit for mark-to-market margin account" should be shown as a deposit under the head "current assets".

7.3 Accounting for Open Positions

Position left open on the Balance Sheet date must be accounted for. Debit/ credit balance in the "mark-to-market margin-Equity index futures account", maintained on global basis, represents the net amount paid/ received on the basis of movement in the prices of index futures till the Balance Sheet date. Keeping in view 'prudence' as a consideration for preparation of financial statements, provision for anticipated loss, which may be equivalent to the net payment made to the broker (represented by the debit balance in the "mark-to-market margin-Equity index futures account") should be created by debiting the profit and loss account. Net amount received (represented by credit balance in the "mark-to market margin-Equity index futures account") being anticipated profit should be ignored and no credit for the same should be taken in the profit and loss account. The debit balance in the said "mark-to-market margin-Equity index futures account", i.e., net payment made to the broker, may be shown under the head "current assets, loans and advances" in the Balance Sheet and the provision created there against should be shown as a deduction there from. On the other hand, the credit balance in the said account, i.e., the net amount received from the broker, should be shown as a current liability under the head "current liabilities and provisions in the Balance Sheet".

7.4 Accounting at the Time of Final Settlement

This involves accounting at the time of final settlement or squaring-up of the contract. At the expiry of a series of equity index futures, the profit/ loss, on final settlement of the contracts in the series, should be calculated as the difference between final settlement price and contract prices of all the contracts in the series. The profit/ loss, so computed, should be recognised in the profit and loss account by corresponding debit/ credit to "mark-to-market margin-Equity index futures account". However, where a balance exists in the provision account created for anticipated loss, any loss arising on such settlement should be first charged to such provision account, to the extent of the balance available in the provision account, and the balance of loss, if any, should be charged to the profit and loss account. Same accounting treatment should be made when a contract is squared-up by entering into a reverse contract. It appears that, at present, it is not feasible to identify the equity index futures contracts. Accordingly, if more than one contract in respect of the series of equity index futures contracts to which the squared-up contract pertains is outstanding at the time of the squaring of the contract, the contract price of the contract so squared-up should be determined using First-In, First-Out (FIFO) method for calculating profit/ loss on squaring-up. On the settlement of an equity index futures contract, the initial margin paid in respect of the contract is released which should be credited to "Initial margin Equity index futures account", and a corresponding debit should be given to the bank account or the deposit account (where the amount is not received).

7.5 Accounting in Case of a Default

When a client defaults in making payment in respect of a daily settlement, the contract is closed out. The amount not paid by the Client is adjusted against the initial margin. In the books of the Client, the amount so adjusted should be debited to "mark-to-market-Equity index futures account" with a corresponding credit to "Initial margin-Equity index futures account". The amount of initial margin on the contract, in excess of the amount adjusted against the mark-to market margin not paid, will be released. The accounting treatment in this regard will be the same as explained above. In case, the amount to be paid on daily settlement exceeds the initial margin the excess is a liability and should be shown as such under the head 'current liabilities and provisions', if it continues to exist on the Balance Sheet date. The amount of profit or

loss on the contract so closed out should be calculated and recognised in the profit and loss account in the manner dealt with above.

7.6 Disclosure Requirements

a. The amount of bank guarantee and book value as also the market value of securities lodged should be disclosed in respect of contracts having open positions at the year end, where initial margin money has been paid by way of bank guarantee and/ or lodging of securities.

b. Total number of contracts entered and gross number of units of equity index futures traded (separately for buy/ sell) should be disclosed in respect of each series of equity index futures. The number of equity index futures contracts having open position, number of units of equity index futures pertaining to those contracts and the daily settlement price as of the Balance Sheet date should be disclosed separately for long and short positions, in respect of each series of equity index futures.

Note: Same Procedure is to be followed for Equity stock Futures also.

8. ACCOUNTING FOR OPTIONS

The Institute of Chartered Accountants of India has issued guidance note on accounting for index options and stock options from the view point of the parties who enter into such contracts as buyers/ holder or sellers/ writers.

Following are the guidelines for accounting treatment in case of cash settled index options and stock options:

8.1 Accounting at the Inception of a Contract

The seller/ writer of the option is required to pay initial margin for entering into the option contract. Such initial margin paid would be debited to 'Equity Index Option Margin Account' or to 'Equity Stock Option Margin Account', as the case may be. In the Balance Sheet, such account should be shown separately under the head 'Current Assets'. The buyer/ holder of the option is not required to pay any margin. He is required to pay the premium. In his books, such premium would be debited to 'Equity Index Option Premium Account' or 'Equity Stock Option Premium Account', as the case may be. In the books of the seller/ writer, such premium received should be credited to 'Equity Index Option Premium Account' or 'Equity Stock Option Premium Account' as the case may be.

8.2 Accounting at the Time of Payment/ Receipt of Margin

Payments made or received by the seller/ writer for the margin should be credited/ debited to the bank account and the corresponding debit/ credit for the same should also be made to 'Equity Index Option Margin Account' or to 'Equity Stock Option Margin Account', as the case may be. Sometimes, the client deposit a lump sum amount with the trading/ clearing member in respect of the margin instead of paying/ receiving margin on daily basis. In such case, the amount of margin paid/ received from/ into such accounts should be debited/ credited to the 'Deposit for Margin Account'. At the end of the year the balance in this account would be shown as deposit under 'Current Assets'.

8.3 Accounting for Open Positions as on Balance Sheet Dates

The 'Equity Index Option Premium Account' and the 'Equity Stock Option Premium Account' should be shown under the head 'Current Assets' or 'Current Liabilities', as the case may be. In the books of the buyer/ holder, a provision should be made for the amount by which the premium paid for the option exceeds the premium prevailing on the Balance Sheet date. The provision so created should be credited to 'Provision for Loss on Equity Index Option Account' or to the 'Provision for Loss on Equity

Stock Options Account', as the case may be. The provision made as above should be shown as deduction from 'Equity Index Option Premium' or 'Equity Stock Option Premium' which is shown under 'Current Assets'. In the books of the seller/ writer, the provision should be made for the amount by which premium prevailing on the Balance Sheet date exceeds the premium received for that option. This provision should be credited to 'Provision for Loss on Equity Index Option Account' or to the 'Provision for Loss on Equity Stock Option Account', as the case may be, with a corresponding debit to profit and loss account. 'Equity Index Options Premium Account' or 'Equity Stock Options Premium Account' and 'Provision for Loss on Equity Index Options Account' or 'Provision for Loss on Equity Stock Options Account' should be shown under 'Current Liabilities and Provisions'. In case of any opening balance in the 'Provision for Loss on Equity Stock Options Account' or the 'Provision for Loss on Equity Index Options Account', the same should be adjusted against the provision required in the current year and the profit and loss account be debited/ credited with the balance provision required to be made/ excess provision written back.

8.4 Accounting at the Time of Final Settlement

On exercise of the option, the buyer/ holder will recognise premium as an expense and debit the profit and loss account by crediting 'Equity Index Option Premium Account' or 'Equity Stock Option Premium Account'. Apart from the above, the buyer/ holder will receive favourable difference, if any, between the final settlement price as on the exercise/ expiry date and the strike price, which will be recognised as income. On exercise of the option, the seller/ writer will recognise premium as an income and credit the profit and loss account by debiting 'Equity Index Option Premium Account' or 'Equity Stock Option Premium Account'. Apart from the above, the seller/ writer will pay the adverse difference, if any, between the final settlement price as on the exercise/ expiry date and the strike price. Such payment will be recognised as a loss. As soon as an option gets exercised, margin paid towards such option would be released by the exchange, which should be credited to 'Equity Index Option Margin Account' or to 'Equity Stock Option Margin Account', as the case may be, and the bank account will be debited.

8.5 Accounting at the Time of Squaring off an Option Contract

The difference between the premium paid and received on the squared off transactions should be transferred to the profit and loss account. Following are the guidelines for accounting treatment in case of delivery settled index options and stock options: The accounting entries at the time of inception, payment/ receipt of margin and open options at the Balance Sheet date will be the same as those in case of cash settled options. At the time of final settlement, if an option expires un-exercised then the accounting entries will be the same as those in case of cash settled options. If the option is exercised then shares will be transferred in consideration for cash at the strike price. For a call option the buyer/ holder will receive equity shares for which the call option was entered into. The buyer/ holder should debit the relevant equity shares account and credit cash/ bank. For a put option, the buyer/ holder will deliver equity shares for which the put option was entered into. The buyer/ holder should credit the relevant equity shares account and debit cash/ bank. Similarly, for a call option the seller/ writer will deliver equity shares for which the call option was entered into. The seller/ writer should credit the relevant equity shares account and debit cash/ bank. For a put option the seller/ writer will receive equity shares for which the put option was entered into. The seller/ writer should debit the relevant equity shares account and credit cash/ bank. In addition to this entry, the premium paid/ received will be

transferred to the profit and loss account, the accounting entries for which should be the same as those in case of cash settled options.

9. TAXATION OF DERIVATIVE TRANSACTION IN SECURITIES

Taxation of Profit/ Loss on derivative transaction in securities Prior to Financial Year 2005–06, Transaction in derivatives was considered as speculative transactions for the purpose of determination of tax liability under the Income-tax Act. This is in view of Section 43(5) of the Income-tax Act which defined speculative transaction as a transaction in which a contract for purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips. However, such transactions entered into by hedgers and stock exchange members in course of jobbing or arbitrage activity were specifically excluded from the purview of definition of speculative transaction.

In view of the above provisions, most of the transactions entered into in derivatives by investors and speculators were considered as speculative transactions. The tax provisions provided for differential treatment with respect to set off and carry forward of loss on such transactions. Loss on derivative transactions could be set off only against other speculative income and the same could not be set off against any other income. This resulted in payment of higher taxes by an assessee.

Finance Act, 2005 has amended Section 43(5) so as to exclude transactions in derivatives carried out in a "recognised stock exchange" for this purpose. This implies that income or loss on derivative transactions which are carried out in a "recognised stock exchange" is not taxed as speculative income or loss. Thus, loss on derivative transactions can be set off against any other income during the year. In case the same cannot be set off, it can be carried forward to subsequent assessment year and set off against any other income of the subsequent year. Such losses can be carried forward for a period of 8 assessment years. It may also be noted that securities transaction tax paid on such transactions is eligible as deduction under Income-tax Act, 1961.

10. SECURITIES TRANSACTION TAX ON DERIVATIVES TRANSACTIONS

As per Chapter VII of the Finance (No. 2) Act, 2004, Securities Transaction Tax (STT) is levied on all transactions of sale and/ or purchase of equity shares and units of equity oriented fund and sale of derivatives entered into in a recognised stock exchange. The rate is prescribed in Finance Act of the relevant year.

11. APPLICABILITY OF TAX AUDIT IN CASE OF DERIVATIVE (F&O) TRADING

Since income from derivative trading is considered as normal business income, therefore normal rules as applicable to tax audit as stated in Section 44AB will be applicable in case of F&O trading also.

12. CALCULATION OF TURNOVER IN CASE OF F&O TRADING

Determination of turnover in case of F&O is one of the important factors for every individual for the income-tax purpose. Turnover must be firstly calculated, in the manner explained below:

1. The total of positive and negative or favorable and unfavorable differences shall be taken as turnover.
2. Premium received on sale of options is to be included in turnover.
3. In respect of any reverse trades entered, the difference thereon shall also form part of the turnover.

Here, it makes no difference, whether the difference is positive or negative. All the differences, whether positive or negative, are aggregated and the turnover is calculated.

13. MAINTENANCE OF BOOKS OF ACCOUNTS IN CASE OF F&O TRADING

Since income from F&O Trading is considered as normal business income, therefore, normal rules for the maintenance of Books of accounts as stated in Section 44AA of the Income-tax Act' 1961 are applicable. These rules can be summarised as follows:

1. If there is loss in F&O trading or the Net profit is less than 8% of the turnover or the turnover exceeds Rs. 1 crore, then provisions of Tax Audit are applicable and in order to get tax audit done, maintenance of books of account are mandatory.

2. If there is a profit in F&O and the profit is 8% or more of total turnover, then only the income has to be declared as business income and accordingly ITR has to be filed. There will be no need to maintain books of accounts.

CHAPTER

10

Accommodation Entries

1. BACKGROUND

1.0 Accommodation entry is a financial transaction between the two parties where one party enters the financial transaction in its books to accommodate the other party. These transactions are accommodated mostly in lieu of cash of equal amount and commission charged over and above at certain fixed percentage for providing such accommodation entry. These accommodation entries are taken by various beneficiaries for introducing their unaccounted cash into their books of accounts without paying the due taxes. An entry operator is the person who is in the business of giving accommodation entries in lieu of cash/ cheque of equal amount after charging certain percentage of commission in cash.

1.1 When we refer to an entry of loan transaction as 'fake loan' received from a 'paper company', it invariably means that such entry represents unaccounted money of the person in whose books of account the money has been credited as loan and the lender company is only a conduit for routing the money back to the books of account of that person. However, despite having knowledge of this fact and knowing the techniques and methods used by the assessees for this purpose, it remains a huge challenge for the tax authorities to prove these facts in the tax proceedings.

1.2 In an economy, where unaccounted income is a big menace, there is always an effort by the tax evaders to bring their unaccounted income back to their books of account without paying any tax on the same. Routing of the unaccounted income back into the books of account disguised as loan or share capital is one of widely used method by the tax evaders in our country. The method is most prevalent and perhaps also one of the most organized one to bring the unaccounted money back to the books of account and even the established business houses resort to the same.

1.3 The process to bring the money back in this manner is commonly known in business parlance as 'Jamakharchi entries' or 'accommodation entries'. This is a well-organized racket controlled and conducted by persons known as *entry providers.* Kolkata is undoubtedly the *Mecca* of such operations, liberally providing entries to the business concerns all over the country but other business hubs such as Mumbai and Delhi are also

not far behind in running the organized rackets of accommodation entries. Although, there is no correct estimation of unaccounted income being brought back in the books of accounts in this manner, the magnitude of the same, without any doubt, is significant and huge.

1.4 The method of providing accommodation entry entails breaking up large amounts of money into smaller, less-suspicious amounts. In India, this smaller amount has to be below Rs. 50,000/- as deposit of cash below this amount does not require submission of PAN to the bank authorities. The money is then deposited into one or more bank accounts either by multiple people or by a single person over an extended period of time. Also, even larger amounts are deposited in the banks with PAN numbers of individuals who are mostly illiterate and work for these *entry operators* for small salary or commission. The money is then routed through various *paper companies* controlled by these operators. These companies are incorporated by taking care of all formalities such as registering with ROC but having only postal addresses with no real office or employees. The directors of such companies are again individuals who are mostly illiterate or semiliterate and work for the *entry operators* for small salaries or commission.

1.5 At first sight, most of the paper companies would pass of as finance, investment or technology companies. But as the *entry operators* would secretly admit, these are only paper companies used to route the unaccounted income and, at the same time, clean hordes of unaccounted income for their clients. The companies used for routing the unaccounted money are basically *fake companies* that exist for no reason other than to 'layer' the entries for ultimate passing on to the end beneficiary. They take in unaccounted money as "loan or share capital" and pass it on to either another such paper company for 'layering' of the transaction or directly to the beneficiary as loan or share capital.

1.6 As has been exposed from time to time through search and seizure operations by the department, such *entry operators* controls hundreds of bank accounts for depositing cash and hundreds of companies for routing the *entries.* Limited resource and infrastructure of the Registrar of Companies (ROC) perhaps makes it easier for them to incorporate large number of such paper companies without any difficulty. The process, *prima facie,* may appear very simple but it is extremely difficult to expose the whole chain of money deposited and 'layers' through which it is routed back to the beneficiary. The biggest problem is that there is no effective deterrence to curb the activities of these *entry operators.* Even conducting search and seizure operations against them have not really worked as a deterrence and such operations had often ended up in disclosure of 'unaccounted commission income' of these *entry operators,* which definitely could not be the purpose of conducting search and seizure operations against these operators.

1.7 People with a whole lot of unaccounted income typically hire such 'financial experts' to handle the process to bring the money back to books of account without paying tax on the same. The whole idea is to make it impossible for Income-tax Authorities to trace the unaccounted money and it's source during the process of bringing it back to the books of account of the assessee. Hence, the solution at the moment is to handle the individual cases of such *entries* routed back through paper companies at the time of assessment under the purview of available provisions of Income-tax Act and judicial pronouncements in respect of the same.

2. NEW *MODUS OPERANDI* OF ENTRY OPERATION ACTIVITY

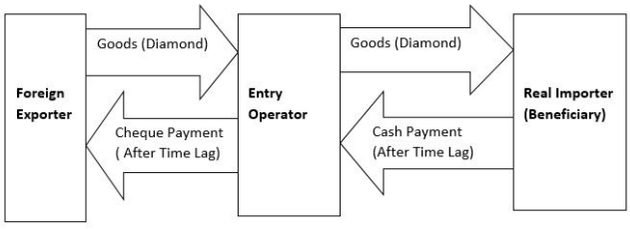
2.0 An entirely new *modus operandi* had come to light recently, wherein there is no deposit of unaccounted cash by the entry operator and hence, no layering to conceal the deposit of cash is required. This entry operation business is prevalent in the cities of Mumbai & Surat. The

search operation conducted on the certain entry operator groups had unfolded the complete details of the new entry operation business.

2.1 There are certain real importers of diamond in the market, who want to actually import diamonds by using unaccounted cash for various reasons. Such importers use the books of accounts of the entry operators/ accommodation entry providers by paying some commission/ brokerage. Thus, the actual importers of diamond (both rough & polished) import the diamonds in the names of the various concerns operated by the entry operators. In general, such imports are not paid back immediately and there is a substantial time lag in the actual import of goods and the payments. Thus, the imports are usually on credit for a long period of time, which may even extend to more than a year.

2.2 On the receipt of the import consignment by the entry operator, the diamonds are handed over to the real importer, after getting it duly cleared from the Customs through CHA (Clearing House Agents). Thus, in reality there is no stock of actual diamonds with the entry operators and only a book stock is created in the bogus concerns run and managed by the entry operators. It is pertinent to note that the transaction with the real importer is not recorded in the regular books of accounts of the entry operator. The real importer also doesn't record these actual purchase of diamonds made from the entry operator in it's books of account. At this stage, the real importer doesn't pay anything to the entry operator and just takes away the actual physical diamonds imported.

2.3 Needless to clarify here, the entry operator only lends his name for the purposes of import. In fact, the entire liasoning with the foreign party, negotiation of price, quality of goods, guarantee for payment of imports etc. is the responsibility of the real beneficiary who has taken away the diamonds. It is only on the directions of the real importer that the foreign exporter sends the goods (diamonds) to the entry operator. Of course, the real importer pays in cash for the imported diamonds to the entry operator, for making further payment to the foreign exporter through banking channels, but that happens after a substantial time gap. Hence, this leg of transaction with the real importer gets squared off, as "Goods Against Cash". The "Goods" are given by the "Entry Operator" and the "Cash" is given by the "Real Importer". Of-course, commission is paid by the Real Importer to the Entry Operator for name lending and for providing the books entries to the real importer. The entire transaction in this regard is explained by way of a flow chart, as below:



2.4 Against the stock created in the books of account of the Entry Operator, bogus sale bills are issued to diamond traders and processing houses, engaged in cutting & polishing of diamonds. Such diamond traders and processors usually purchase diamonds from the grey market in cash and to regularize these purchases they take purchase bills from the accommodation entry providers. The bogus purchase bill of diamonds are also taken by the diamond processing companies to artificially inflate the purchases and to reduce their taxable profits. Such purchases though bogus, are recorded in the books of account at both ends and hence the payments are made by such beneficiaries through cheque to the entry operators. Since, there is no actual purchase of goods, the cheque payment received by the entry operator is returned back in cash. Of course, commission is deducted by the entry operator for providing the bogus bill to the traders/ processors of diamonds. Thus, this leg of transaction gets squared off through "Cheque against Cash". The "Cheque" is given by the purchase party and the "Cash" is given by the "Entry Operator".

2.5 There are large number of business like the real estate developers, builders, manufacturing concerns etc. in which a large amount of unaccounted cash is generated and such entities want to route this unaccounted cash into the regular books of account. Thus, such parties have surplus unaccounted 'cash' with them and they want to convert it into 'cheque'. Such business entities approach the entry operators to get loans/ advances in the 'cheque' form against payment of 'cash'. Thus, this leg of transaction gets squared off, as "Cash against Cheque". The "Cash" is given by the "loan/ advance" beneficiary & the cheque is given by the "Entry Operator".

2.6 It may be noted that the cash received from these beneficiary entities, which are mainly builders & developers is passed on to the diamond processors/ traders, who has obtained bogus purchase bills. It is also pertinent to note that the settlement of cash amongst the various parties takes place through the well-established system of *Angarias*. It may be noted that the cheque received against accommodation entry of bogus purchases may be used by the entry operator either to pay off the foreign exporter of diamonds or to give accommodation entry of Loans/ Advances to builders/ developers.

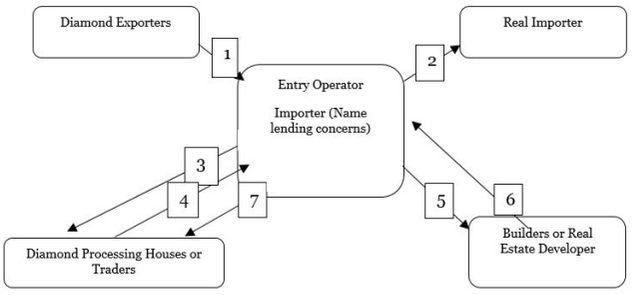
2.7 The final leg is the return of loan/ advance through cheque by the beneficiary entities, which has earlier taken such accommodation entry of loans/ advances. The payment is received through the banking channel by the entry operator and is duly recorded in the regular books of account. Needless to mention here, the entry operator has to pay back to such beneficiary entities an amount equal to the loan amount in cash. Hence, this leg of transaction gets squared off, as "Cheque against Cash". The cheque is given by the "loan/ advance" beneficiary and the "Cash" is given by the "Entry Operator".

2.8 Thus, the amount built up in the regular books of account by way of return of loan & that given by the parties, who has taken bogus purchase bills, is travelling to pay back to the foreign exporter of diamond, whose bills have been outstanding for a long period of time. Thus, the real import creditors are finally cleared, at the last stage. At this stage, finally cash is received by the entry operator from the real importer, as the payment has to be made to the foreign exporter of an equivalent amount through the banking channels.

2.9 To sum up, it is to be noted that each cheque transaction is backed by an equivalent amount of cash and vice-versa at all stages. The cheque transactions are duly recorded in the books of the entry operator, but the unaccounted cash transactions are not recorded at all. The entry operator charges a commission from the parties concerned at all stages, which is it's unaccounted cash commission income. Thus, at no stage, cash is routed through the accounts of any of the entry operating concern and entire cheque/ RTGS transactions mentioned above are done through banking channels.

2.10 The complete *modus operandi* is represented diagrammatically, as below:

1st Stage Transactions

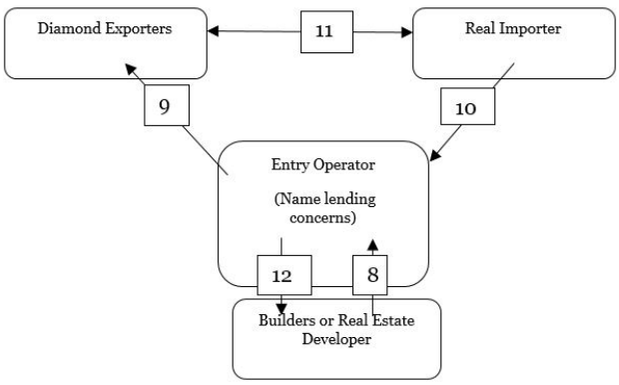


Explaination Nodes for 1st Stage Transactions:

1. Diamond import by real importers. Credit period is 6 months to 2 years.
2. Diamonds handed over to the Real Importer after clearance by Customs, without recording it in the books of account.
3. Sale bill issued to Processing houses/ Traders against book stock.

4. Payment received by cheque against bogus sales made by the Entry Operator.
5. Cheque given to persons, who need accommodation entry of loan, like Builders & Developers.
6. Cash is paid by the builder to the Entry Operator.
7. Cash is paid by the Entry Operator to the Diamond Processing Houses and trader against the bogus bill issued by them.

2nd Stage Transactions (after 6 months to 2 years)



Explaination nodes for 2nd Stage Transactions:

1. Return of loan/ advance by the builder/ developer to the Entry Operator by cheque.
2. Cheque payment to the exporter by the Entry Operator against credit imports.
3. Cash is paid by the Real Importer to the Entry Operator for the actual diamonds taken at 1st stage.
4. Internal adjustment by the real importer and the foreign exporter, located abroad.
5. Cash returned back by the Entry Operator to Builders/ Developers.

3. ACTION UNDER SECTION 68 OF THE INCOME-TAX ACT 1961

3.0 The recourse available to the Assessing Officers on detection of such fake loans is to tax the same under Section 68 of the Income-tax Act 1961, as unexplained cash credit. The provision relating to cash credit, as in Section 68, was provided for the first time in the Income-tax Act 1961 (Act No.43 of 1961), as there was no corresponding provision in the Income-tax Act, 1922. It would be pertinent to note that Section 68 is a new Section in comparison with the provision of the Income-tax Act, 1922 and it is a culmination of a series of judicial pronouncements under the provisions of the Income-tax Act, 1922.

3.1 For the purpose of better comprehension, the Section 68 may be dissected, as below:

1. Where any sum is found credited in the books of an assessee;
2. Maintained for any previous year; and
3. Assessee offers no explanation about the nature and source thereof; or
4. The explanation offered by him, is not, in the opinion of the Assessing Officer, satisfactory;
5. The sum so credited may be charged to Income-tax;
6. As the income of the assessee, of that previous year.
7. Where the assessee is a company (not being a company in which the public are substantially interested), and the sum so credited consists of share application money, share capital, share premium or any such amount by whatever name called, any explanation offered by such assessee-company shall be deemed to be not satisfactory, unless:
   - The person, being a resident in whose name such credit is recorded in the books of such company also offers an explanation about the nature and source of such sum so credited; and
   - Such explanation in the opinion of the Assessing Officer aforesaid has been found to be satisfactory

3.2 The initial catchphrase of the Section is *"where any sum is found credited in the books of account of the assessee"* meaning thereby that Section 68 is attracted, where an entry relating to a sum is found to have been credited in the books of the assessee, which *prima-facie* implies, existence of books and recording of a sum which the Assessing Officer considers as doubtful. A perusal of Section 68 shows that in relation to the expression 'books', the emphasis is on the word 'assessee'. In other words, such books have to be the books of the assessee himself and not of any other person and books of account of even a firm in which the assessee is a partner cannot be considered as the books of the assessee as held in the case of *Smt. Shanta Devi vs. CIT [1988] 171 ITR 532 (Punj. & Har.).*

3.3 In *CIT vs. Frostair (P.) Ltd. [2012] 26 taxmann. com 11 (Delhi),* it was held that the assessee was under a burden to explain nature and source of share application money received in a given case and he had to establish shareholder's identity; genuineness of transaction; and creditworthiness of shareholders. On being informed that assessee had accepted share capital from some companies which were engaged in providing bogus entries, in form of loan and share application money, the Assessing Officer asked for details under Section 142(1) of the Act. The assessee submitted a list of 18 shareholders from which Assessing Officer discerned that PAN/ GIR No. of shareholders was not correct, they were not available at addresses given and they were not even filing their ITRs with concerned officers. It was held by the Hon. High Court that since Assessing Officer had examined all facts in exhaustive manner, addition under Section 68 and, consequently initiation of penalty proceedings were justified.

3.4 Another decision of Hon. Delhi High Court in the case of *CIT vs. N R Portfolios Pvt. Ltd. in ITA Nos. 134/ 2012* would be of help to the assessing officers in dealing with the challenges of taxing of the *accommodation entries* under Section 68 of the Act. In this case, the assessee, a company, received Rs. 35 lakhs towards share allotment. As the shareholders did not respond to summons, the AO assessed the said sum as an unexplained credit under Section 68. On appeal, the CIT(A) and Tribunal relied on *Lovely Exports 216 CTR 195 (Del) & Divine Leasing 299 ITR 268 (SC),* and held that as the assessee had furnished the PAN, bank details and other particulars of the share applicants, it had discharged the onus of proving the identity and credit-worthiness of the investors and that the transactions were not bogus. It was also held that the AO ought to have made enquiries to establish that the investors had given accommodation entries to the assessee and that the money received from them was the assessee's own undisclosed income. On appeal by the department the Hon. High Court, held reversing the decision of Ld. CIT(A) & Hon. Tribunal that:

> *Though in previous decisions (Lovely Exports) it was held that the assessee cannot be faulted if the share applicants do not respond to summons and that the Revenue authorities have the wherewithal to compel anyone to attend legal proceedings, this is merely one aspect. An assessee's duty to establish the source of the funds does not cease by merely furnishing the names, addresses and PAN particulars, or relying on entries in the Registrar of Companies website. The company is usually a private one and the share applicants are known to it since the shares are issued on private placement basis. If the assessee has access to the share applicant's PAN or bank account statement, the relationship is closer than arm's length. Its request to such concerns to participate in Income-tax proceedings, would, from a pragmatic perspective, be quite strong. Also, the concept of* "shifting onus" *does not mean that once certain facts are provided, the assessee's duties are over. If on verification, the AO cannot contact the share applicants, or the information becomes unverifiable, the*

onus shifts back to the assessee. At that stage, if it falters, the consequence may well be an addition under Section 68 (A. Govindarajulu Mudaliar 34 ITR 807 followed).

3.5 While dealing with doubtful cash credits: Is it necessary for the Assessing Officer to establish that the money had come back to the books of the assessee from the coffers of the assessee? This issue has been adjudicated upon by the Hon'ble Delhi High Court in the case of *Commissioner of Income-tax vs. Independent Media (P.) Ltd. [210 TAXMANN 14(Delhi)(2012]),* which is significant in the context of '*entries'* taken from paper companies. In this case, it was alleged by the Investigation wing that the assessee-company received share capital from those persons who had given statements before Investigation wing that they were entry providers giving accommodation entries after receiving cash and after charging their commission. The assessee furnished PAN of subscriber-companies, share application forms, board resolutions, copy of bank statement, pay orders, confirmation from subscribers, their Income-tax returns, copies of their Balance Sheets, etc. However, it was held by the Hon. Court that if explanation adduced by assessee with regard to identity and creditworthiness of subscriber-companies and genuineness of transactions was not acceptable for valid reasons, Assessing Officer could make addition under Section 68 and for that purpose he would not be under any duty to further show or establish that monies emanated from coffers of assessee-company. The Hon. Court further observed as under:

"We are unable to uphold the view of the Tribunal that it is incumbent upon the Assessing Officer, on the facts and circumstances of the case, to establish with the help of material on record that the share monies had come or emanated from the assessee's coffers. Section 68 of the Act casts no such burden upon the Assessing Officer. This aspect has been considered more than 50 years back by the Supreme Court in the case of A Govindarajulu Mudaliar vs. CIT [1958] 34 ITR 807 where precisely the same argument was advanced before the Supreme Court on behalf of assessee. The argument was rejected by the Court."

3.6 The Hon'ble Court further referred that in the above case, Shri Venkatarama Iyer, J. speaking for the Court observed as under:

"Now the contention of the appellant is that assuming that he had failed to establish the case put forward by him, it does not follow as a matter of law that the amounts in question were income received or accrued during the previous year, that it was the duty of the Department to adduce evidence to show from what source the income was derived and why it should be treated as concealed income. In the absence of such evidence, it is argued, the finding is erroneous. We are unable to agree. Whether a receipt is to be treated as income or not, must depend very largely on the facts and circumstances of each case. In the present case the receipts are shown in the account books of a firm of which the appellant and Govindaswamy Mudaliar were partners. When he was called upon to give explanation he put forward two explanations, one being a gift of Rs. 80,000/- and the other being receipt of Rs. 42,000/- from business of which he claimed to be the real owner. When both these explanations were rejected, as they have been it was clearly upon to the Income-tax Officer to hold that the income must be concealed income. There is ample authority for the position that where an assessee fails to prove satisfactorily the source and nature of certain amount of cash received during the accounting year, the Income-tax Officer is entitled to draw the inference that the receipt are of an assessable nature. The conclusion to which

the Appellate Tribunal came appears to us to be amply warranted by the facts of the case. There is no ground for interfering with that finding, and these appeals are accordingly dismissed with costs."

3.7 Hence, it is not necessary to establish that the money came back to the books of the assessee had actually emanated from his coffers.

3.8 In ordinary circumstances, the assessee's burden is confined to prove creditworthiness of creditor with reference to transaction between assessee and creditor. It was so held in *Nemi Chand Kothari vs. CIT [2004] 136 Taxmann 213 (Gau.)* that a harmonious construction of Section 106 of the Evidence Act and Section 68 of the Income-tax Act will be that though apart from establishing the identity of the creditor, the assessee must establish the genuineness of the transaction as well as the creditworthiness of his creditor. The burden of the assessee to prove the genuineness of the transactions as well as the creditworthiness of the creditor must remain confined to the transactions, which have taken place between the assessee and the creditor. What follows, as a corollary, is that it is not the burden of the assessee to prove the genuineness of the transactions between his creditor and sub-creditors nor is it the burden of the assessee to prove that the sub-creditor had the creditworthiness to advance the cash credit to the creditor, since these aspects may not be within the special knowledge of the assessee.

3.9 However, on this issue, it is important to keep in mind that it may not be the responsibility of the assessee to prove source of source but nothing precludes the assessing officer to make enquiry in respect of the source of the source as well to establish that both the source and it's source are part of a larger chain of 'paper companies' engaged in the business of providing *accommodation entries to the willing tax evaders.* Once a valid presumption is raised by way of an enquiry about the genuineness of transaction between the source and it's source, the same could be used as an evidence to doubt the integrity of the source of the assessee and to raise a valid presumption about the transaction between the assessee and its source being not genuine.

4. TEST OF HUMAN PROBABILITIES

4.0 As has been discussed earlier, the issue of shifting of onus in the cases of cash credit is a complex one and each case has to be examined in its own facts and circumstances. Hence, in the cases of 'fake loan' from 'paper companies' the theory of preponderance of human probability as pronounced by the Hon. Apex Court in the cases of *CIT vs. Durga Prasad More [1971] 82 ITR 540* and *Sumati Dayal vs. CIT [1995] 80 Taxmann 89/ 214 ITR 801 (SC)* is of utmost importance. In cases where it has been established that the source company is a mere 'paper company' solely engaged in the activity of providing accommodation entries, the presumption on the basis of human probability may be referred to by the assessing officers to fortify their findings.

4.1 The Hon. Supreme Court in *CIT vs. Durga Prasad More [1971] 82 ITR 540,* at pages 545–547 made a reference to the test of human probabilities in the following factual situation:

"… Now we shall proceed to examine the validity of those grounds that appealed to the learned judges. It is true that an apparent must be considered real until it is shown that there are reasons to believe that the apparent is not the real. In a case of the present kind a party who relies on a recital in a deed has to establish the truth of those recitals, otherwise it will be very easy to make self-serving statements in documents either executed or taken by a party and rely on those recitals. If all that an assessee who wants to evade tax is to have some recitals made in a document either executed by him or executed in his favour then the door will be left wide-

open to evade tax. A little probing was sufficient in the present case to show that the apparent was not the real. The taxing authorities were not required to put on blinkers while looking at the documents produced before them. They were entitled to look into the surrounding circumstances to find out the reality of the recitals made in those documents.

Now, coming to the question of onus, the law does not prescribe any quantitative test to find out whether the onus in a particular case has been discharged or not. It all depends on the facts and circumstances of each case. In some cases, the onus may be heavy whereas, in others, it may be nominal. There is nothing rigid about it. Herein the assessee was receiving some income. He says that it is not his income but his wife's income. His wife is supposed to have had two lakhs of rupees neither deposited in banks nor advanced to others but safely kept in her father's safe. Assessee is unable to say from what source she built-up that amount. Two lakhs before the year 1940 was undoubtedly a big sum. It was said that the said amount was just left in the hands of the father-in-law of the assessee. The Tribunal disbelieved the story, which is, prima facie, a fantastic story. It is a story that does not accord with human probabilities. It is strange that the High Court found fault with the Tribunal for not swallowing that story. If that story is found to be unbelievable as the Tribunal has found, and in our opinion rightly, then the position remains that the consideration for the sale proceeded from the assessee and, therefore, it must be assumed to be his money.

It is surprising that the High Court has found fault with the Income-tax Officer for not examining the wife and the father-in-law of the assessee for proving the department's case. All that we can say is that the High Court has ignored the facts of life. It is unfortunate that the High Court has taken a superficial view of the onus that lay on the department.

'…Science has not yet invented any instrument to test the reliability of the evidence placed before a Court or Tribunal. Therefore, the Courts and Tribunals have to judge the evidence before them by applying the test of human probabilities. Human minds may differ as to the reliability of a piece of evidence. But, in that sphere, the decision of the final fact-finding authority is made conclusive by law." (p. 545)

4.2 The test of human probabilities has been emphasized in yet another decision of the Hon. Supreme Court in the case of *Sumati Dayal vs. CIT [1995] 80 Taxmann 89/ 214 ITR 801 (SC)*. It was held in this case that in view of Section 68, where any sum is found credited in the books of the assessee for any previous year, the same may be charged to Income-tax as the income of the assessee of the previous year, if the explanation offered by the assessee about the nature and source thereof, is, in the opinion of the Assessing Officer, not satisfactory. In such case there is *prima facie* evidence against the assessee, *viz.*, the receipt of money, and if he fails to rebut the same, the said evidence being unrebutted can be used against him by holding that it is a receipt of an income nature. While considering the explanation of the assessee, the department cannot, however, act unreasonable.

4.3 Why this decision is so important while dealing with cases of 'fake loan' from 'paper companies', because it acknowledges that what is apparent may not be real and test of human probabilities has to be applied to understand if the apparent is real and if the transaction fails to withstand the test of human probabilities, it has to be treated as a non-genuine transaction, even if documentary evidences suggest otherwise. In this case, the assessee, a dealer in art pieces, had

shown income from horse-race winnings in two consecutive accounting years. The Assessing Officer did not accept this and made addition under Section 68, which was confirmed by the Appellate Assistant Commissioner. Thereafter, the assessee approached the Settlement Commission. The Settlement Commission also took the view that the claim of winnings in races was false and what were passed off as such winnings really represented the appellants taxable income from some undisclosed sources. The Hon. Supreme Court also agreed with the Settlement Commission saying that after considering the surrounding circumstances and applying the test of human probabilities the Commission had rightly concluded that the assessee's claim about the amount being her winnings from races was not genuine.

4.4 The test of human probability often comes to the help of the Revenue to track unaccounted income. This could be of a great help in exposing the 'fake loans' from 'paper companies' as well. In one of its special kinds, the test of human probability made an assessee pay huge amount of tax in *Som Nath Maini vs. CIT [2008] 306 ITR 414 (Punj. & Har.)*. In this case, the assessee in his return declared loss from sale of gold jewellery and also declared a short-term capital gain from sale of shares so that the two almost match each other. This simple tax planning became ineffective after the Assessing Officer disbelieved the astronomical share price increase applying the test of human probability. The Assessing Officer observed that short-term capital gains were not genuine in as much as the assessee had purchased 45000 shares of *Ankur International Ltd.* At varying rates from Rs. 2.06 to Rs. 3.1 per share and sold them within a short span of six-seven months at the rate varying from Rs. 47.75 paisa to Rs. 55. Even though the two respective transactions for purchase and sale of shares were routed through two different brokers, yet the Assessing Officer did not believe the astronomical rise in share price of a company from Rs. 3 to Rs. 55 in a short-term. The assessee lost its case before the Tribunal. Confirming the order of the Tribunal, the Punjab and Haryana High Court held that the burden of proving that income is subject to tax is on the revenue but, on the facts, to show that the transaction is genuine, burden is primarily on the assessee. As per the Court, the Assessing Officer is to apply the test of human probabilities for deciding genuineness or otherwise of a particular transaction. Mere leading of the evidence that the transaction was genuine, cannot be conclusive.

5. RESPONSIBILITY OF THE ASSESSING OFFICER

5.0 There is no denying to the fact that in the case of cash credit, the primary onus is on the assessee and where the assessee fails to discharge such onus, the Assessing Officer is well within his jurisdiction to treat the cash credit as income of the assessee within the meaning of Section 68 of the Act. However, the balance of burden in the case of cash credits is delicate and complex and unless and until the Assessing Officer shows his intention to make enquiry to examine the truth, the additions made under Section 68 in the cases of 'fake loan' from 'paper companies' would not get affirmation from the appellate authorities. In the cases of loans from 'paper companies', the additions are often made by the Assessing Officers by highlighting the defects in the submission of the assessee without making further enquiries, which does not help the cause of the Revenue. In most of the cases, additions *u/s* 68 of the Act are being made by the AOs, citing the following reasons:

1. The assessee has provided name, address and PAN of the creditor but did not provide confirmations from him.
2. Confirmatory letters from the creditors were filed but the creditors were not produced for examination.
3. Summons issued under Section 131 to the creditors, but they did not respond to the summons.
4. The letters sent to the creditors at the given address returned unserved with comment "not found" or "incorrect address".

5. The confirmation of the creditor was filed but his bank statement was not produced or his credit worthiness has not been established.

5.1 It must be kept in mind that such instances, could be the circumstances to have a valid doubt as to the genuineness of the loan but these alone would not suffice to draw a valid presumption that the cash credit represents income of the assessee. Under Section 68 of the Act, the Assessing Officer has jurisdiction to make enquiries with regard to the nature and source of the sums credited in the books of account of the assessee and it is immaterial as to whether the amount so credited is given the colour of a loan or share application money or sale proceeds. The use of the words "any sum credited in the books" in Section 68 indicates that the Section is very widely worded and the Assessing Officer is not precluded from making an enquiry as to the true nature and source of the sum credited in the accounts even if it is credited as loan from another company. The Assessing Officer would be entitled, and it would indeed be his duty to enquire whether the alleged creditors do in fact exist or not and whether the loan shown in the garb of a credit from an entity is nothing but an *accommodation entry* routed through a *paper company* solely existing for the purpose of providing such *accommodation entries.*

5.2 Although, given in the context of share application money, the decision of Hon. Delhi High Court in the case of *CIT vs. Sophia Finance Ltd. 205 ITR 98 (full bench)* is extremely significant where explaining and rather over ruling some observations of the division bench in *Steller Investment* case, the full bench observed as under:

> *14. It is not necessary nor desirable to give examples to indicate under what circumstance Section 68 can or cannot be invoked. What is clear, however, is that Section 68 clearly permits an ITO to make enquiries with regard to the nature and source of any or all the sums credited in the books of account of the company irrespective of the nomenclature or the source indicated by the assessee. In other words the truthfulness of the assertion of the assessee regarding the nature and the source of the credit in its books of account can be gone into by the ITO. In the case of Stellar Investment Ltd. (supra) the ITO had accepted the increased subscribed share capital. Section 68 was not referred to and the observations in the said judgment cannot mean that the ITO cannot or should not go into the question as to whether the alleged shareholders actually existed or not. If shareholders are identified and it is established that they have invested money in the purchase of shares then the amount received by the company would be regarded as capital receipt and to that extent the observations in the case of Stellar Investment Ltd. (supra) are collect but if, on the other hand, the assessee offers no explanation at all or the explanation offered is not satisfactory then, the provisions of Section 68 may be invoked. In the latter case Section 68. being a substantive Section, empowers the ITOs to treat such a sum as income of the assessee which is liable to be taxed in the previous year in which the entry is made in the books of account of the assessee.*

5.3 It is, therefore, imperative on the part of the Assessing Officer to make enquires as to the nature and source of cash credits and bring evidence on record cogent material to show that the loan is a fake one representing an *accommodation entry from a paper company.* The nature and extent of enquiry has to be case-specific so as to raise a valid presumption to treat the loan as income of the assessee. However, in the case of accommodation entries received through paper companies, the Assessing Officer can easily bring certain facts on record to highlight that the loan received actually represents an *accommodation entry.* It could be proved that the company providing loan exists only on paper, it has no employees, the address given is only a postal address and the company does not have any physical setup at the given address, the same

address is used as postal address for multiple companies indulging in the same activity of providing *accommodation entries.* It could also possibly be proved that the directors of the companies are non-existent or even if they exist, they are illiterate or semi illiterate individuals, who do not have competence or credibility to operate any investment company. Examining the directors on oath under Section 131 could also be a way to carry the enquiry further so as to prove that they may be acting on behalf of some other person for petty amounts received as salary or commission. It could also be proved that the company is receiving huge amount as loan and giving the same to other concerns without any apparent motive of conducting any actual business and the directors of the company are not even aware of such huge transactions made by the company. Necessary enquiries may also be made from the bank to examine the bank account of the creditor and also to examine the person who has introduced such bank accounts. In some of the cases, it may have been held that the assessee do not have responsibilities to prove the source of the source, but nothing precludes the Assessing Officer from examining the source of the source and conduct enquiries to bring on record that the entry operating entities were working in collusion with each other for providing *accommodation entries.*

5.4 As discussed earlier, in number of decisions the efforts of the Assessing Officers have been acknowledged and applauded by the appellate authorities, where enquires have been made and additional information and evidences have been brought on record to raise a valid presumption to the effect that the cash credit is taxable *u/s* 68 of the Act. It is, therefore, necessary that the Assessing Officers properly analyse the individual cases before them and, instead of solely depending on the submissions of the assessee and highlighting the deficiency of the same, conduct independent enquiry and bring additional material facts and evidences on record before taxing the accommodation entries as unexplained cash credits *u/s* 68 of the Act.

6. CASE STUDY ON ACCOMMODATION ENTRIES IN CURRENCY DERIVATIVES THROUGH MCX

Case Summary: Case pertains to a member of MCX–SX providing accommodation entries by purchase and sale of currency derivatives executed simultaneously through two terminals in the same office.

Pre-Search Intelligence: The Investigation Directorate, Kolkata gathered that one Mr. SS through his group concern, MVPL, was providing accommodation entries of loss or profit in currency derivatives. It had membership of MCX–SX (MCX stock Exchange Limited). It was also gathered that Mr. SS maintained details of unaccounted cash transactions related to his business of accommodation entries in a pen drive which was rarely brought to the office.

Survey Action Initiated Which was Converted into Search and Seizure: Based on these specific inputs as to when the pen drive was available in the office, a survey action *u/s* 133A of the IT Act, 1961 was initiated in his office where unaccounted cash of Rs. 25 lakh was found in addition to unaccounted [kutcha] cash books in the pen drive. The survey was converted into Search and Seizure operation on 25.03.2013 *u/s* 132 of the Income-tax Act, 1961.

Search Revelations

1. Unaccounted (Kutcha) Cash Books Seized: During the search, the print outs of unaccounted [kutcha] cash books maintained in the pen drive of the taxpayer for the FY 2006–07 onwards till date were found and seized.
2. Accommodation Entries Detected: It was found that the cash receipts by Mr. SS from different parties were on account of entry of profit which Mr. SS had paid by cheques; and cash payments by him to different parties were on account of entry of loss which he had received by cheques. The beneficiaries, to the extent of approximately Rs. 176 crore within Kolkata,

and approximately Rs. 50 crore outside, were identified, and the information was passed on to their Assessing Officers.

3. Undisclosed Commission Income: Further, Mr. SS admitted undisclosed commission income of ₹ 7 crore.

Unique *Modus Operandi*: The *modus operandi* followed by Mr. SS was a new one.

1. One future contract (Lot) represented 1000 Dollars. The original rate at which a contract was purchased was known as contract rate. Future contract was settled at the spot rate at the expiration of the contract which was determined by Exchange or it would be sold before expiration at the prevailing market rate. The contract expiry period was normally 30 days.
2. In case the purchase transaction was not reversed, it would be carried forward to the future contract of next month when it would be settled at the spot rate which is determined by the Exchange. When a party in need of loss in currency derivatives to set it off against its normal business income approached the broker, the broker would search a party which wanted profit entry of currency derivatives.
3. The orders of purchase and sale of currency derivatives were executed simultaneously by punching the same on the two terminals located in the same office, by following method of 123 so that no third party entered into the transaction.
4. In case there were no real buyers or sellers corresponding to a real sale or purchase on any occasion, some dummy parties were maintained by the broker in whose accounts the sale or purchase were executed.

The following indications present in normal transactions proved the case of accommodation entries:

i. In normal transactions, Margin was to be collected at fixed rate of 1% of contract value plus variable margin decided by the Exchange. However, no margin or inadequate margin was taken from the parties by the broker in case of accommodation entries;

ii. Normal transactions were frequent and spread over the year whereas in the case of accommodation entries, the transactions were one time or occasional and mostly near the year end; and

iii. Continuity of losses without settling the margin money or settling the account was also an indicator of accommodation entries which did not happen in normal cases.

7. CASE STUDY ON ENTRY OF BOGUS SHARE APPLICATION

Case Summary: Profits enhanced by price manipulation and SEBI Provisions circumvented by using various bogus entities. These profits then set off by bogus losses, ploughed back as share capital through a dummy broker. Post search investigation of share applicants, directors, brokers and postal authorities led to unravelling of accommodation entry racket.

Pre-Search Intelligence

1. Price manipulation of Guar Seeds and Guar Gum**:** Discreet enquiries conducted in the cases of the R Group and B Group showed that they were indulging in stocking up and price manipulation in case of Guar seeds and Guar gum. This was done through various entities, effectively controlled by these groups, to circumvent market regulators like SEBI and FMC.
2. Profits set off by Bogus Commodity Losses: The profits so earned were set off by booking bogus commodity losses through tainted brokers to reduce tax liability. Such transaction of booking bogus commodity losses was done with the help of broker like which was also covered in search.
3. Bogus Share Application Money**:** After booking such bogus losses, the same

profits were ploughed back as bogus share application money and premium in companies of R Group and B Group.

Search Revelations: Based on the above information, search and seizure operations on R group, B Group and the Broker were carried out on 29.01.2013. During the course of search, evidences gathered established that the said broker group was used to book bogus losses to set off profit earned in Guar gum/ guar seeds trade. On the face of it, R group disclosed an amount of Rs. 100 crore and Betul group disclosed Rs. 60 crore as money ploughed back as share application money on account of these fictitious commodity trading losses.

Post-Search Investigations

1. Post Search investigations on B Group: During post search investigations conducted in the case of B Group, it was found that to give the colour of genuineness, B Group had introduced one Mr. S.K. as broker to arrange Rs. 280 crore from various parties.
2. Notices *u/s* 133(6) were issued to such share applicants. To investigate their genuineness, a series of enquiries were conducted at Kolkata. It was found that such addresses of said share applicant entities were not in existence or not operational. Information was collected from postal department, Kolkata. Postmen who served 133(6) notices were examined on oath.
3. Directors of Companies Bogus: The Directors of such entities were also traced and examined on oath. These Directors accepted that they are people of no means and are Directors for namesake and dummy.
4. Accomodation Entry Operators Revealed: Examination of postmen and dummy Directors revealed details of various accommodation entry operators who effectively controlled entities which provided share application money to B Group. Such entry providers were traced and examined. On examination, various accommodation entry providers deposed on oath that they had provided accommodation entries to B Group. Moreover, Mr. S.K. on examination deposed that he had no role in the transactions of share application money. He also deposed that he was introduced for namesake and that too post facto.

Search Outcome: Thus, entire *modus operandi* of obtaining bogus share application money of B group was conclusively established. This enquiry resulted in detection of bogus share application money to the tune of Rs. 280 crore.

Enquiries were also conducted on Mumbai based parties indulging in providing share application money to various companies of R Group. On enquiries, it was found that R group had taken accommodation entries to the tune of Rs. 160 crore from various accommodation entry providers. Enquiries with namesake/ dummy directors led to identification of accommodation entry providers controlling such entities. These accommodation entry providers accepted on oath that they had given accommodation entries to various groups including R group. During this investigation, money trail was followed up to two Mumbai based builders (independent from search groups). The independent surveys conducted in these two builders resulted in disclosure of around Rs. 110 crore.

CHAPTER

11

Penny Stocks, Shell Companies, CCM and Bogus LTCG

1. INTRODUCTION

1.0 Penny Stocks are those listed shares, which trade at a very nominal price since they represent those companies which are paper companies only with no real activity being carried on by them. Thus, Penny Stock is a stock that trades at a relatively low price and market capitalization. These types of stocks are generally considered to be highly speculative and high risk because of their lack of liquidity, large bid-ask spreads, small capitalization and limited following and disclosure. These companies/ stocks are used for arranging bogus long term capital gain, with the sole objective of claiming tax exemption benefits under Section 10(38) of the I.T Act, 1961. These penny stocks were used in an organised manner by tax evaders to avoid taxable income and converting black money into white. Such organised rackets were running in Kolkata from where bogus LTCGs were arranged countrywide.

1.1 The Directorate of Investigation, Kolkata had undertaken the investigation of accommodation entries of Long Term Capital Gain (LTCG) on a much large scale and as a result, had been able to identify a large number of beneficiaries of LTCG. As a result of this investigation, 64811 beneficiaries involving bogus LTCG of nearly Rs. 38,000 crores were identified. In LTCG investigations, the approach was to first identify the 'Penny Stocks' and then zero in on the individuals who had traded in them.

1.2 The Long Term Capital Gain in shares is defined by the value of such shares, which are shares of a stock exchange listed company, held by assesse for more than a year. As per Section 10(36) & 10(38) of the Act, such LTCG was exempt from tax if:

1. The asset, which is transferred, is a long term capital asset being an eligible equity share in a company.
2. Such shares are purchased on or after March 1, 2004.
3. Taxpayers hold such shares for more than 12 months of period.

4. Furthermore, other condition is that Securities transactions Tax (STT) must be paid on such transaction.
5. It should be sold through recognised stock exchange.

2. TYPES OF PENNY STOCK COMPANIES

2.1 Broadly speaking there are following two types of companies used for the penny stock entry operation:

i. An old already listed company, the entire shareholding of which is bought by the syndicate to provide LTCG entries. These are generally dormant company with no real business and with huge accumulated losses.

ii. A new company which is floated just for the purpose of giving LTCG entries. Such new companies are often floated after the initial booking is complete and the capital base is decided keeping in mind the entries to be provided.

3. *MODUS OPERANDI*

3.1 Before the actual transaction of bogus LTCG even actually commences, it had been noted that there are brokers in different towns, who contact prospective clients and take paper booking of the LTCG entries. The commission to be paid to the operators is decided at this stage, however, no money is paid. Once the booking is complete, the operators have a reasonably good idea of how much LTCG is to be provided, along with the break-up of individual beneficiaries. This data is essential to decide which penny stock or companies is to be used for providing bogus LTCG and which beneficiary is going to buy how many shares.

3.2 The modus-operandi of the bogus LTCG of penny stocks can be easily understood with the help of a flow-chart, as under:

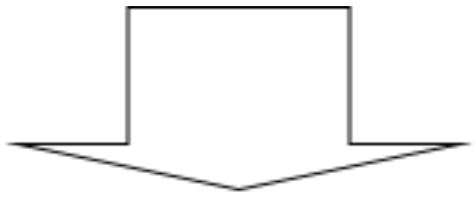
A person "B" (Beneficiary) is in possession of unaccounted money and who wants to bring this unaccounted money into his books. At the same time this person also desires to avoid paying any tax whatsoever when this money is brought into the books.

Now this person "B" approaches the Entry operators "O". Operator is a person who manages the overall scheme of the scam. An operator maintains a complex nexus of various paper/ bogus entities and is also in control of some companies whose shares are listed on one or the other Stock Exchanges. He maintains a close nexus with share brokers.

When approached by "B", operator "O" asks "B" to buy some specific number of shares of a specific listed company. These shares can be bought by the Beneficiary either on the exchange itself or the operator may arrange for the issue of these shares to the beneficiary through preferential allotment i.e. through private placement (this is an off-market transaction). These shares are allotted to the beneficiaries at very low price.

Thereafter, the Operator starts rigging the price of the shares through circular trading and increases the price of the shares, with the help of share brokers and bogus clients. The prices are rigged to an optimum amount over a period of time.

Once a period of 1 year (for claim of exemption on LTCG *u/s* 10 (38)) is over, the operator asks the beneficiary to deliver the unaccounted cash. Once the unaccounted cash has been delivered by the beneficiary, the same is then routed by the operator to the books of various Paper/ Bogus Companies which ultimately buy the shares belonging to the beneficiary at high prices. The cash is routed to the books of bogus companies through a maze of various other paper companies so as to avoid the direct cash trail.



Once the cash has been routed to the books of paper/ bogus companies, which are registered as clients to the brokers, the operator instructs the Beneficiary to place a sell option for the shares belonging to the beneficiary, in a particular lot size on a particular date and time.

At the same time the operator instructs the paper/ bogus companies maintained by him to buy the shares of the beneficiary on the exchange at the predetermined particular date and time.

In this way the shares of the beneficiaries are bought by the paper/ bogus companies and the unaccounted money of the beneficiary is routed to the books of the beneficiary as a bogus entry of LTCG.

4. ENTITIES INVOLVED IN BOGUS LTCG TRANSACTIONS

4.0 The modus-operandi of bogus LTCG involves three different individual/ entity. They are the promoter of 'Penny stock' companies (also known as syndicate member), the share brokers & the entry operator. Many a times the three categories of individuals perform overlapping roles. The three categories of individuals/ entities are described in greater details below:

Syndicate Members

4.1 They are the promoters of the Penny Stock companies, who own the initial shareholding mostly in the name of paper companies either in a fresh IPO or purchased from the shareholders of a dormant company. They are usually a group of 4–5 individuals, who are also referred to as Syndicate Members and are sometimes also referred to as Operators. Their nominees are directors of the Penny Stock companies, which is indirectly controlled by them through such dummy directors. The whole operation is managed by them and hence, they get commission income on the bogus LTCG transactions. Their name, however, seldom appears in the actual transactions.

4.2 The promoters/ directors of the penny stock company are paid some cash commission and in return they allow the operator to manage the

affairs of the company. The operator then issues shares of these penny stock companies to the beneficiaries through the route of preferential allotment (Private Placement). Thus, the promoters/ directors of the companies work hand in glove with the operator to implement this scheme of availing bogus LTCG.

4.3 As per the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, the shares that are allotted through private placement, have a lock-in period of 1 year. Therefore, these shares can be sold by the allottees only after a period of one year from the date of allotment. This qualifies them for the benefit of claim of exempt LTCG.

The Brokers

4.4 They are registered brokers through whom shares are traded both online and off-line. They are fully aware of the nature of transactions and get paid a commission over and above their normal brokerage. Some of the big broking houses are also indulging in such transactions mostly through sub-brokers. It is pertinent to note that even Calcutta Stock Exchange has registered itself as a broker with BSE and has given a large number of terminals to sub-brokers, who are dealing into such type of transactions. The brokers often compromise on KYC norms of the clients to help the Syndicate Members.

The Entry Operators

4.5 They are individuals who control a large number of paper/ shell companies which are used for routing cash for the transactions as well as buying and selling shares during the process of price rigging. They work for commission to be paid by the Syndicate Members. To cut cost sometimes in smaller operations, the same group performs more than one function.

5. THE VARIOUS LEGS OF BOGUS LTCG TRANSACTION

5.0 The bogus LTCG transaction involves three legs in which it is completed and the same are described below:

i. **Purchase of Share by the Beneficiary:** In this the beneficiary is sold a fixed number of shares at a nominal rate. The price and the number of shares to be purchased are decided on the basis of the booking taken and the value up to which share price would be rigged. This leg of the transaction is mostly off-line. This is done to save on STT using the loophole in Section 10(38) of the IT Act, which places restriction of trading by payment of STT only on sale of shares and not on their purchase.

ii. **Price Rigging:** After the shares have been purchased by the beneficiaries, the syndicate members start rigging the price gradually through the brokers. In these transactions, the volume of shares traded is almost negligible. Two fixed brokers who are in league with the Syndicate buy shares at a fixed time and at a fixed price. These low volume transactions are managed through paper companies of entry operators.

iii. **Final Sale by the Beneficiary:** This is done after the beneficiary has already held the share for one year. The period of holding may be a little more to match the amount of booking with the final rate. The beneficiary is contacted either by the Syndicate member or the Broker (Middle man) through whom the initial booking was done. The beneficiary provides the required amount of cash which is routed through some of the paper companies of the entry operator and is finally parked in one company which will buy the share

from the beneficiary. The paper company issues cheque to the beneficiary, through the stock brokers of a recognised stock exchange.

5.1 The above mentioned methodology is referred to as Conventional Method. Another method which is also used quite often is called Merger Method. The methodology adopted in Merger Method is explained in the foregoing paragraphs.

Merger Method

5.2 In this method, the Operator first forms a Private Limited Company and the shares are allotted to beneficiary individuals at par. This private limited company is then amalgamated/ merged with a listed penny stock company by a High Court order. The High Courts do sometimes refer the case to the jurisdictional PCIT before passing amalgamation order. The PCIT, however, neither has the time nor the wherewithal/ jurisdiction to investigate. The result is that the blatant tax evasion is getting stamped by the Hon'ble High Courts.

5.3 Depending on the capital of the amalgamating and amalgamated companies, the investors are allotted stock of the listed companies in the same proportion. The capital of the Penny stock listed company and the private limited company are so arranged that the beneficiaries post-merger, get shares of listed company in the ratio 1:1, thus the investor gets equal number stocks of the listed company.

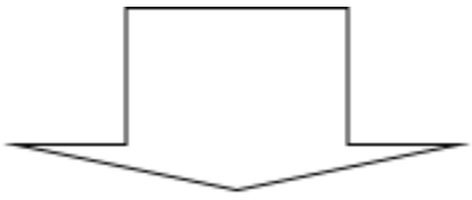
5.4 The promoters of the listed penny stock companies run the syndicate, while the brokers and the entry-operators, through whose paper/ shell companies cash are routed, are merely commission agents. The penny stock listed company is such that though its capital base is small its market capitalization is many times its capital base. This is managed again through small volume predetermined transaction amongst members of the syndicate. The prices of shares are thus manipulated at 20 to 25 times the face value.

6. BOGUS SHORT TERM CAPITAL LOSS

6.0 While LTCG is booked while the share price is going up, the downward journey is used by the operators for booking bogus losses. People who have huge profit take the Short Term Capital loss (STCL) to set-off their profit. The methodology used is the same. The beneficiary who wants loss buys the share at a high rate from the beneficiary who is taking LTCG. The loss taking beneficiary pays cheque to the LTCG taking beneficiary and the cash provided by the LTCG beneficiary is returned to the Loss taking beneficiary. The operator deducts his commission before payment by cash. As prices crash the loss taking beneficiary sells these shares bought at high value for small value resulting in artificial loss.

6.1 The modus-operandi of the bogus Short Term Capital Loss of penny stocks can be understood with the help of the following flow-chart:

A Company "B" (Beneficiary) foresees that it is going to have huge profits in its books of accounts. The Company wishes to reduce its taxable income by taking entry of bogus loss in its books of account so as to set-off the profit that it is going to earn.



Now this Company "B" then approaches the Entry operator "O". Operator is a person who manages the overall scheme of the scam. An operator maintains a complex nexus of various paper/ bogus entities and is also in control of some companies whose shares are listed on one or the other Stock Exchanges.

When approached by "B", the operator asks the "B" to buy some specific number of shares of a specific listed company. These shares are bought by the beneficiary company at very high price on the stock exchange. The shares which are bought by the beneficiary company are held by either the paper/ bogus entities maintained by the operator or by the beneficiaries who wish to take an entry of bogus LTCG in their books.

Thereafter, the Operator rigs the price of the shares through circular trading and decreases the price of the scrip. The prices are rigged to an optimum amount over a period of time.

Once the price of the shares has been decreased by circular trading, the operator asks the beneficiary company to place a sell option for the shares belonging to the beneficiary in a particular lot size on a particular date and time.

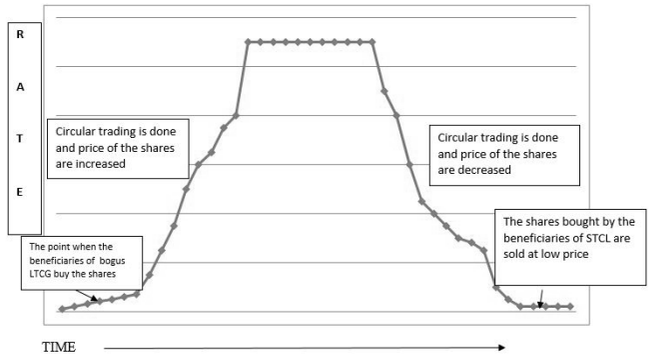
The loss that is incurred by the Beneficiary company is returned back to the company in cash.

In this way the beneficiary companies desirous of booking a loss in their books of account get an entry of bogus STCL which is set-off against the regular profit of the company.

7. VARIATION IN PRICE OF PENNY STOCK WITH TIME

7.0 A pictorial depiction of the variation of the price of penny stock share with time is typically as under:

Here the shares held by beneficiaries of bogus LTCG are sold to either paper entities or to the beneficiaries of bogus STCL



8. BASIC FEATURES OF PENNY STOCK TRANSACTION

8.0 All such penny stock companies have to be identified from the trading patterns of the share brokers, statements of entry operators and the post survey inquiries. They all have very common financial and trading pattern, which is enumerated below:

1. Initial allotment of shares to beneficiaries is generally done through preferential allotment.
2. The market price of shares of these companies rise to very high level within a span of one year.

3. The trading volume of shares during the period, in which manipulations are done to raise the market price, is extremely thin.
4. Most of the purported investors are returned their initial investment amount in cash. Only small amount is retained by the operator as security. Thus, an enquiry would reveal that most of the capital receipts through preferential allotment or other means would have found their way out of system as cash.
5. Most of these penny stock companies have no business at all. Few of the companies which have some business do not have the credentials to justify the sharp rise in the market price of their shares.
6. The sharp rise in market price of the shares of penny stock entities is not supported by fundamentals of the company or any other genuine factors.
7. An analysis in respect of persons involved in transactions apparently carried out to jack up the share prices reveals that many common persons/ entities (paper companies) were involved in trading in more than 1 LTCG companies.
8. Names of most of the LTCG companies are changed during the period of the scam.
9. Most of the companies split the face value of shares, which is probably done to avoid the eyes of market analysts.
10. The volume of trade jumps manifold immediately when the market prices of shares reach at optimum level, a point where the gain is booked by the beneficiaries. This maximum is reached around the time when the initial allottees have held the shares for one year or little more and, thus, their gain on sale of such shares would be eligible for exemption from taxation.
11. The prices of the shares fall very sharply after the shares of LTCG beneficiaries have been off loaded through the pre-arranged transactions on the Stock Exchange floor/ portal to the Short Term Loss seekers or dummy paper entities.
12. The shares of these companies are not available for buy/ sell to any person outside the syndicate. This is generally ensured by way of synchronized trading by the operators amongst themselves and/ or by utilizing the mechanism of upper/ lower circuit of the Exchange.

9. SOP FOR FRAMING ASSESSMENT ORDER IN PENNY STOCK CASES

9.0 The Assessing Officer is expected to consider, inter alia, the following aspects during the scrutiny of penny stock cases while drafting the assessment order:

1. Identify all the shares in which the assessee has done transactions.
2. Identify the penny stocks out of the same by matching the list in the ITS. A new tab called 'Penny Stock' has been developed in ITS, wherein information has been made available (Refer EFS instruction No. 53) for relevant PAN, FY.
3. Examine the net outcome of the share transaction to determine whether the assessee has taken entry of Loss or Gain. Also, check whether the assessee has claimed exemption *u/s* 10(38) of the Act or not.
4. Examine the mode of acquisition of the shares (Preferential allotment/ amalgamation scheme/ online transaction or other). Check necessary documentation for acquisition of shares. Mention whether or not the volume of the shares was increased by splitting the share and by issue of bonus share.

5. Statement of the assessee is required to be recorded *u/s* 131 of the Act for confronting the assessee the findings of the investigation wing and for gathering further evidences. Examine the assessee about his familiarity with share market and mode of acquisition of shares. At this stage AO should make available to the assessee copies of all the statements of brokers, entry operators etc. recorded by investigation wing and all other material relevant to assessee's case so that principles of natural justice are not violated.
6. Refer to the financials of the penny stock and bring out on record as to how the movement of the price was abrupt, unrealistic and not based upon any genuine parameters. The help of sites like www. moneycontrol.com can be taken.
7. Refer to the trade details and identify connecting entities/ intermediaries, especially the exit providers. The operators of the penny stock can be identified from the investigation report from Kolkata.
8. List of the PANs of Exit providers is to be obtained from the trade logs from ITS details. The data like name and address can be obtained from the ITD system.
9. Examination of the bank accounts of these entities is extremely important, as this will lead to the identification of the audit trail of cash movement.
10. While recording the statement of the assessee, if the assessee identifies a broker or an intermediary who has helped him in arranging the transaction, then an effort has to be made to examine these brokers or the intermediaries to further strengthen the case of the department.
11. Identify the statements of operators and share brokers connected with the penny stock related to the assessee from the investigation reports and discuss the statements in the assessment order.
12. The demat account of the assessee needs to be called for the relevant period in which these shares in which LTCG/ STCL claimed are held. The said demat account needs to be examined to find out whether the assessee had held the penny stock for minimum one year or not.
13. The copy of the broker's ledger & broker's contract notes & Global Report of share transactions needs to be called for and examined.
14. If SEBI has passed any order or has taken any action against the related parties then same has to be made part of assessment order. Wherever available, any adverse order of SEBI (link given in the ITS) relating to the scrip/ entity should also be discussed.
15. A show cause has to be issued to the assessee pointing out the findings of the investigations and pointing out the defects in the claim of the LTCG/ Share transactions/ STCL.
16. An assessment order is to be drafted containing all the points discussed above and assessee specific facts and part of statements which are related to the assessee's case. The *modus operandi* has to be discussed in brief and effective use of the relevant statements should be made in the assessment order.
17. After considering assessee's submissions, point-wise rebuttal of assessee's arguments to be given and facts of the case and investigations conducted to be mentioned to conclude that LTCG or STCL claimed is prearranged and therefore bogus and is required to be rejected and the entire sale

proceeds received on sale of shares is to be added as taxable income *u/s* 68 of the act, without any eligibility of exemption *u/s* 10(38) of the act.

18. The relevant judicial decisions needs to be discussed in the assessment order, while countering decisions relied upon by assessee.

19. In cases were assessment *u/s* 147 r.w.s 143 is pending, all the steps as per SC decision in the case of *GKN Driveshafts (India) Ltd vs. Income-tax* Officer needs to be followed.

10. CASE STUDY ON PENNY STOCKS

Case Summary: It pertains to usage of paper entities for multilayered accommodation entries. Investigation of the cash trail led to unearthing of nationwide network of entry providers, who helped introduce capital through bogus Long Term Capital Gains/ Fictitious Share Capital/ Share Premium.

Pre-Search Intelligence: Revealed introduction of about Rs. 100 crores as share capital at a huge premium in the Group Companies. Of this Rs. 60 crores was *prima facie* from suspected sources. Further, Rs. 28.5 crores of this suspected share capital was received from various old listed companies with registered offices at Baroda, Hyderabad, Ahmedabad and Mumbai.

Post-Search Revelations: Revealed that XYZ Ltd Group individuals had Returned in A.Y. 2011–12 exempt LTCG of Rs. 69 crores from the sale of shares of Prraneta Industries Ltd. Enquiries revealed that Prraneta Industries Ltd. was a shell company even though it had been in existence since 1995. And while the company performed no genuine activity, its share price increased from Rs. 2.5 to Rs. 79 per share from April 2009 to February 2011, i.e. more than a 30 fold increase in less than 2 years.

Secondary Information Analysis

1. Share trading data of Prraneta Industries Ltd. was sourced from Bombay Stock Exchange. On analysis of this data it was found that XYZ Ltd Group entities offloaded their holding at Rs. 50-80, to book exempt LTCG. Further, counter parties behind BOLT showed names of some 25 companies occurring repeatedly. This was a startling discovery indicating that a big accommodation entry racket was being run. This racket facilitated accommodation entry of share premium and exempt LTCG from listed companies against payment of cash by beneficiaries.

2. Detailed analysis of MCA and ITD database of companies so identified led to identification of a further network of 100 companies which were being used for providing accommodation entries. This exercise also unraveled the following facts:

- Majority of these companies were being run from 12–15 addresses located in Mumbai/ Thane and had common Directors.
- Though these companies were not making any profit they all had huge capital base.
- These companies had incurred huge short term and long term capital losses.

Follow-up Action: Another Search and Survey operation launched in April, 2013. This led to seizure of following clinching evidences:

- Details of 220 bank accounts and more than 300 Blank and signed cheque books were found. These pertained to 212 companies including 16 listed companies, managed by SCS and were used for accommodation entries.
- Directors of the companies were found to be dummy and for namesake. Statements of persons who were Directors in large number of companies, were recorded

wherein they have admitted that they are mere name lenders.

- PAN Cards, seals of the companies, records of statutory compliance etc. were seized/ impounded.
- Evidence of synchronized trading to artificially raise share price of the listed companies managed by SCS was found and seized.
- The entry wise details of receipt of cash against which cheques for accommodation entries were issued to the respective beneficiary parties was seized.
- Noting of 16 routes, for layering of funds through bank accounts of the companies managed and controlled by SCS have been found and seized. Through these routes SCS had standardized the procedure for layering of funds through his group companies, wherein only the 'route number' had to be specified to employees so as to layer the funds.
- Statements of the key employees and SCS were recorded wherein they explained the evidence and accepted the involvement of 212 companies including 16 listed companies managed by SCS in providing accommodation entries.

Final Outcome

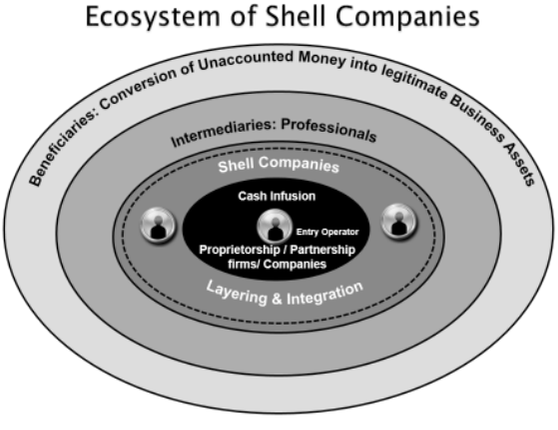
Breaking of an accommodation entry racket wherein evidence of bogus long term capital gains, share capital, share premium, unsecured loans etc. to the tune of ₹ 3000 crores has been detected. Further, perusal of the seized evidence and sustained investigation over a period of two years led to identification of other operators like SCS who were involved in the business of giving accommodation entries unraveling an organized racket.

Detailed references to SEBI and SFIO were made in F.Y. 2014–15. On the basis of the inputs by the Unit, cognizance of the menace of manipulation of Penny Stocks has been taken by SEBI. Finally, SEBI for the first time had started adjudicating on the issue of penny stocks share price rigging to book exempt LTCG.

11. ECOSYSTEM OF SHELL COMPANIES & WHOLE OF GOVERNMENT APPROACH

Background

11.1 The Government had analysed the Ecosystem under which the Shell Companies thrive, identified the Key Players which collaborate with each other, to facilitate a series of Fraudulent Activities from money laundering, tax evasion, siphoning off funds, manipulation of stock market, holding of property in benami names, misuse of banking channels to falsification of Financial Statements. The Ecosystem has a network of Entry Operators managing a large number of "Shelf Companies" along with Proprietorship/ Partnership concerns, Professionals working as mediators between the Operators and Beneficiaries as depicted below:



11.2 To tackle the menace of burgeoning shell companies a Co-ordinated Multi-agency Approach, adopting "Whole of Government" strategy is required. The Standard Operating Procedure (SOP) drawn for tackling the shell companies issues being important from the perspective of the Assessing Officer & Investigation Wing is reproduced hereunder:

- The agency which first comes into the possession of the documents/ Hard disc will continue to be custodian of the originals.
- Whenever there is seizure of Hard Discs, all agencies will make two cloned copies of the Hard Discs, one will be kept under sealed cover and the other will be a working copy.
- In case of cloning of Hard disc, the provisions of Section 65 B of the Indian Evidence Act will be strictly complied with.
- Other agencies will make a request for certified copies of the documents or a cloned copy of the hard disc.
- The custodian will ensure handing over of certified copies of the documents/ cloned copies of the Hard disc to the requesting agency within a week of receipt of the request
- Cloned copy of the Hard disc will be made from the working copy
- If there are sufficient/ compelling reasons for not sharing any information, the custodian will record reasons for refusal and communicate the decision to the requesting agency
- It will be the responsibility of the custodian to produce the original documents/ Hard Disc before the court during the prosecution proceedings initiated by the concerned agency

12. TAX EVASION THROUGH CLIENT CODE MODIFICATIONS (CCM)

Introduction

12.1 Client Code Modification (CCM) means modification/ change of the client's code after execution of trades on the portal of a recognised Stock Exchange. The SEBI vide its Circular SMD/ Policy/ Cir-39/ 2001 dated July 18, 2001 made it mandatory for all brokers to use unique client codes for all clients. For this purpose, brokers were directed to collect and maintain in their back office the Permanent Account Number (PAN) allotted by Income-tax Department for all their clients. Thereafter, vide circular no. SMD/ POLICY/ Cir-/ 03 dated February 6, 2003 SEBI mandated that the stock exchanges shall not normally permit changes in the client code except to correct for genuine mistakes. Every client is given a code which is registered with the stock exchanges. The client code modifications permit brokers to rectify human errors when a client inadvertently provides a wrong code or when or a wrong code is punched in by the broker whilst executing the trade. The broker is allowed to change it between 3.30 pm and 4 pm to rectify a genuine error that may have occurred while entering the code. The facility ensures smooth functioning of the system and is to be used as an exception rather than routine.

12.2 However, the client code modification (CCM) especially in the Futures and Options Segment (F&O) was being used as a device to evade taxes, wherein the client codes were modified for booking artificial profits or losses at the fag end (Jan to March) of the Financial year when the book profits/ losses of various clients have crystallized. This is done with an intention to impact the tax liabilities of the pair of clients whose codes are modified. Let us take an example to illustrate the *modus operandi*:

a. Say Mr. X is high net worth individual and he wants a certain amount of loss in a Company–I, which already has crystallized profits in its books. By taking in artificial losses he avoids paying tax on already crystallized profits, as these get set off against the artificially bought loss.

b. As against this say Mr. Y is another client who without paying any taxes wants to launder his cash and introduce it in his books as accounted for funds. Else M/s. Y is a shell company/ non-filer individual/ entity with already huge losses and is ready

to offer itself as a party to CCM as shifting of profits into the company or losses out of the company would not affect its taxable income.

c. Brokers indulging in tax evasion through client code modification would enter a large number of buy/ sell orders in the F & O segment in the name of a client and would close them within the days' trading itself. Some of these transactions would result in loss and some would result in gain and the loss and gain transactions would more or less balance out.

d. Thereafter during the time span allowed for changing the client code the broker would segregate the gain and loss transactions by changing the client codes of the loss and gain transactions.

e. In the scenario mentioned above he would change the client code of loss transactions to that of the Company-I. The pay-out made by the company would be returned back by the broker to Mr. X in cash after deducting a commission for arranging the loss.

f. Similarly, the transactions which resulted in gain the broker would change the client code of transactions to that of Mr. Y. For this he would get equivalent amount and his commission back from Mr. Y in cash.

g. After such manipulated code changing, if the contract notes are called for, the transactions would appear to be genuine and it would seem as if real trade was done by the substituted party, as his client code and not that of the original client is printed on the contract notes.

12.3 This kind of substitution of client code, which is allowed by stock exchange for rectifying genuine punching errors, has been abused by the unscrupulous brokers and their clients.

12.4 Ever since the introduction of client codes, this practice was being used by the brokers to provide accommodation entries of profits and losses to various clients. But over the years this assumed scandalous proportions so much so that use of CCM for malafide reasons was duly acknowledged by the regulatory body i.e. SEBI. An order WTM/ PS/ 09/ DNPD/ APRIL/ 2012 of SEBI dated April 10, 2012 was passed in the matter of modification of client codes of trades against the National Stock Exchange of India Limited (NSE).

12.5 After analysing the month wise trend of the client code modifications and the sudden drop in the number of modifications after the introduction of stringent penalties with effect from July 5, 2011, SEBI concluded that CCM was undertaken by Brokers for purposes other than rectifying genuine punching errors. SEBI categorically stated in the said order that number of errors is a strong indicator whether the errors were genuine or not. It was noted that the brokers enter other fields as well *viz.* price and number of securities purchased/ sold. No modification was allowed in those fields even in case of a genuine error and the broker had to compensate the clients, if he committed a mistake. The cases where the broker had to compensate a client for mistake in data entry were truly rare. If we contrast this to thousands of errors committed in a month in the case of modification of client code, it is but obvious that there would have been some other reason than genuine mistake. SEBI has also clearly recorded that client code modification was being done in cases other than that for rectifying the genuine errors under the garb of existing practices.

12.6 SEBI had in July 2011 imposed a stricter penalty on such modifications to further strengthen the system. SEBI instructed bourses to impose a monetary penalty of 1% of the value of the transaction where the client codes were modified. According to brokers, the penalty was 50 times the yield in the F&O segment.

The average yield in the derivatives segment is 0.02%. SEBI also directed the exchanges to conduct special inspection of trading members to check whether such modifications were being carried on as per the criteria.

12.7 As the real motive behind CCM was to evade taxes, due measures against this practice were also taken by the CBDT. The CBDT vide Notification No. 14 dated 9 March 2011 made three important changes by mandating that:

a. The stock exchange can-not erase the transactions (in respect of cash and derivative market) once registered in the system.

b. The stock exchange will ensure that the modification of client code is for genuine purpose.

c. Every stock exchange which has got recognition under Rule 6DDB shall compulsorily submit a monthly statement in Form 3BB. The Form 3BB has been devised so as to get a clear picture of who did the initial trade and which client code was substituted.

There was substantial fall in CCMs after the above measures were taken.

Illustration of CCM

12.8 Every CCM impacts the profits and losses of a pair of clients. In the discussion below, the client in whose name the order was originally punched is referred to as the "original client" and the client to whom client code profits or losses were transferred by way of CCM is referred to as the "modified client".

12.9 During FY 2008–09 the client code "A091" was modified 2000 times (i.e. the transactions carried out in this code were shifted to other client codes) and this code was the modified client code 2325 times (i.e. the transactions carried out in other codes were shifted to this code). The entire CCMs were carried out during the period 17.02.2009 to 31.03.2009.

a. The effect of the 2000 modifications carried out in the client code "A091" is that profit of Rs. 2,71,19,385/- on F&O transactions had been shifted to other clients, primarily to clients having book losses. Further, when on 2325 times this client was the modified client, this has resulted in shifting of loss aggregating to Rs. 4,40,21,994/- to the client code "A091". Thus, the profits of this client was reduced by Rs. 7,11,41,379/-. It is pertinent to record here that this client was having a profit of Rs. 9,52,73,472/- prior to setting off of the F&O losses. Thus, by resorting to client code modifications in this client, the taxable income had been reduced by Rs.7,11,41,379/-. This brings forth the real intent behind CCM.

Contentions of Assessee & Enquiries by AO

12.10 The contentions raised by the assessee before investigating/ assessing authorities are summaries hereunder:

- CCM allowed at that time
- CCM as tool to remunerate brokers
- Genuine typing error
- CCM used as a tool for Margin Management
- Through CCM largely losses have been transferred within group entities
- CCM carried out throughout the year & not just fag end
- CCM is very small percentage of total trade volume

12.11 All the contentions raised can be dealt with by the Assessing Officers by carrying out data analysis and further enquiring into the following issues:

- The persons from whose client codes the ascertained profits were shifted to the assessee has not paid taxes owing to shifting out of losses or shifting in of the profits.

- It is also required to be demonstrated that the assessee, who has received losses or shifted out profits owing to CCM, has reduced its tax liability.
- Further, it can also be investigated as to whether when loss was incurred by the MCC (owing to CCM) he did not have adequate funds in his account with the Broker, so as to finance the losses.
- Wherever CCM has been claimed to be genuine punching errors, it is required to be established by referring to placement of keys on the keyboard that the mistakes in client codes are not possible as punching errors.
- In cases where the contention is taken that the modifications have been carried out within group entities it is required to be established that the modifications have led to reduction in tax liability of one group entity and has not affected equally the tax liability of the group entity to whom profits have been shifted.

12.12 Thus, CCM is a clear example wherein the regulated stock market mechanism has been subverted so as to manipulate the books of accounts and obtain contrived losses. There are many other issues wherein the stock markets have been subverted so as to manipulate taxable income. Thus, the Investigators are required to keep a track of developments in stock markets especially orders passed by SEBI and other regulators so as to identify newer issues of tax evasion.

CHAPTER

12

GST: One Nation, One Market, One Tax

1. INTRODUCTION

1.1 A comprehensive Goods and Services Tax (GST) was introduced in India from 1st July 2017. The implementation of the GST in India was a historical move, as it marked a significant indirect tax reform in the country. It is a huge step forward in uniform nation-wide collection of indirect taxes. Multiple indirect taxes levied and collected by the Centre and the States are replaced by one tax called the Goods and Services Tax (GST). GST is a tax on supply of goods or services or both. It is a tax on the value addition at every stage of the production-distribution chain, with applicable set offs in respect of the tax paid at previous stages. It is basically a tax on final consumption.

1.2 GST is a destination-based tax that replaces multiple Central taxes and duties levied earlier such as Excise Duty, Service Tax, and local state taxes, i.e., Value Added Tax (VAT), Octroi, Entry Tax, Purchase Tax, Luxury Tax, etc. It is a dual levy with State/ Union territory GST and Central GST. Moreover, inter–state supplies attract an Integrated GST, which is the sum total of CGST and SGST/ UTGST.

1.3 Globally, India is the third country after Canada and Brazil to implement dual GST i.e. central and state level GST.

1.4 It extends to whole of India, including the State of Jammu and Kashmir. With the State of Jammu and Kashmir being part of the GST regime, GST is truly a "one nation, one tax" regime. The whole GST system is backed by a robust IT system. In this regard, Goods and Services Tax Network (GSTN) has been setup by the Government.

2. SUBSUMING OF VARIOUS INDIRECT TAXES OF CENTRE AND STATE

The GST has subsumed Central Excise Duty, Duties of Excise (Medicinal and Toilet Preparations), Additional Duties of Excise (Goods of Special Importance), Additional

Duties of Excise (Textiles and Textile Products), Additional Duties of Customs (commonly known as CVD), Special Additional Duty of Customs (SAD), Service Tax, Central Surcharges and Cesses so far as they relate to supply of goods and services. Amongst state taxes State VAT, Central Sales Tax, Luxury Tax, Entry Tax (all forms), Entertainment and Amusement Tax (except when levied by the local bodies), Taxes on advertisements, Purchase Tax, Taxes on lotteries, betting and gambling, State Surcharges and Cesses so far as they relate to supply of goods and services have also been subsumed.

3. MAJOR ADVANTAGES OF GST

One of the most important benefits of the move is the mitigation of double taxation or the elimination of the cascading effect of taxation. The initiative is now paving the way for a common national market. Indian goods are also expected to be more competitive in international and domestic markets post GST implementation. The major advantages of GST could be summarized as below:

a. One Nation One Tax.

b. Removal of cascading effect of taxes i.e. removes tax on tax.

c. Increased ease of doing business.

d. Low administration cost.

e. Increasing digitalization.

4. APPLICABILITY

4.1 GST is applicable on supply of goods or services which includes almost all kinds of transactions including sales, barter, rental which is made or agreed to be made for a consideration by a person in the course of or furtherance of business.

4.2 There are certain transactions which, even without any consideration, are deemed to be supply and certain transactions which are not treated supply in spite of fulfilling all conditions of supply, e.g. Salary, Sale of land.

4.3 Joint Supply: If supply is a joint supply i.e. consisting of more than one supply of goods or services or both, which is naturally bundled; then that shall be treated to be supply of principal supply contained therein. But if it is not naturally bundled then it will be treated as supply of that particular supply which attracts the highest rate of tax.

4.4 Presently, levy of GST is applicable on all items except petrol, diesel, alcoholic liquor, air turbine fuel and natural gas.

5. OBLIGATION TO PAY TAX

Liability to deposit GST is generally on supplier; but in respect of few notified goods e.g. sale of old vehicles, seized goods, scrap by Government or Local Authorities to registered person and few notified services e.g. advocate services to business entity, goods transport agency services to specified persons; liability to deposit GST is cast upon the receiver.

6. RATES OF GST

Small traders and manufacturers (having turnover less than Rs. 1.00 Cr in preceding year) are given an option to deposit GST @ 1% of their turnover with certain conditions. General rate of GST are 3%, 5%, 12%, 18%, 28% and few items are also liable for compensation cess.

7. EXEMPTION

Government is empowered to exempt certain goods and services in public interest. Notifications No.2/ 2017 and 12/ 2017 dated 28/ 06/ 2017, was issued and many such goods and services were exempted.

8. POINT OF TAXATION

Point of taxation in respect of goods is linked with date of invoice which is compulsory to be issued before or at the time of removal of goods. However, in case of services, point of taxation is date of invoice or payment received whichever is earlier. In other words, in case of supply of services, GST is leviable on advances received also.

9. VALUATION

Valuation of supply is generally the transaction value. But in some cases it cannot be ascertained due to reasons like entire consideration or part consideration being not in monetary value; transaction is between related persons etc. For such instances valuation rules are prescribed. Interest on delayed payment of consideration is also part of the value of supply and subject to GST at the rate of principal supply. However, relaxation is given on interest on late payment; where in point of taxation shall be date of receipt of interest. It is worthwhile to note that normally interest on loan, deposit with bank or otherwise is exempted service.

10. INPUT TAX CREDIT ON INPUT GOODS, CAPITAL GOODS, INPUT SERVICES

10.1 Whatever GST is paid on inward supply of goods or services, is eligible to be set off (termed as input tax credit or ITC) against GST liability of outward supply. This is soul of GST concept, i.e. to avoid cascading effect (tax on tax). Thus if there is no GST on outward supply, no ITC can be availed. However, if there is no tax on outward supply as it is export or supply to SEZ, then ITC can be availed and even refunded. ITC is eligible whether inward supply is goods or capital goods or input services.

10.2 ITC of IGST shall be used to pay IGST first and then CGST and SGST/ UTGST in sequence. Similarly ITC of CGST shall be first used in CGST and then the IGST liability and similarly ITC of SGST shall be first used in SGST and then the IGST liability.

10.3 GST included in the cost of capital asset shall not be capitalized and on such part depreciation cannot be claimed under Income-tax Act 1961. There is certain supply on which ITC is blocked either absolutely or with certain conditions e.g. motor vehicles, construction related inward supply etc.

11. REGISTRATION

11.1 All persons whose aggregate turnover (including turnover of exempted and non-GST items) exceeds 20 lakhs in preceding year are required to get themselves registered under GST Law and pay tax. However, if their total supply constitutes only of exempt supply (school, hospital) they are exempted from registration. On the contrary, irrespective of turnover, if a person is involved in interstate supply then he is compulsorily required to be registered. Person having different places of business in the same state need to take a single registration. However, he may take different registration for different business verticals within the same state. Even if he is opting for single registration within state, he has to mention other places of business as his additional place of business.

11.2 A person can take voluntarily registration also. All registrations are PAN based known as GSTIN having 15 characters. The first two characters represent state code and the next 10

characters represent PAN of taxpayer and last there are check digits, e.g. 23AAACT1234H1ZX.

12. TDS/ TCS

There is a provision for certain class of tax payers to deduct TDS/ TCS like in Income-tax. However, these provisions are not made effective and are deferred.

13. DEBIT NOTE/ CREDIT NOTE

Once any supply is subjected to GST and at later stage taxpayer finds any excess or less GST collection, same can be adjusted by way of credit note or debit note by the person who issued invoice i.e. the supplier. However, time limit to issue credit note is limited to 6 months from the end of financial year.

14. RECORDS AND PERIOD OF RETENTION

All taxpayers are required to maintain prescribed records and accounts and if their turnover exceeds Rs. 2 Crore then an audit by CA/ CWA is also required. These records are generally required to be preserved for 81 months from the end of financial year. A warehouse keeper or transporter, even though they may not be required to get themselves registered, still they are required to maintain certain specified records.

15. RETURNS

All taxpayers are required to file 3 monthly returns and one annual return. However, presently requirement is limited to 2 monthly returns and one yearly return. Delay in filing return is liable for penalty/ late fees.

16. INTEREST ON DEMAND AND REFUND

Any delay in depositing tax shall be liable for interest @ 18% p.a. in case of *suo-motu* deposit, but if Department determines the demand, rate of interest shall be 24% p.a. Similarly, if refund is not granted within 60 days, applicant is eligible for interest @6% p.a.

17. GST-IGST, CGST, SGST/ UTGST, CESS

GST tax is IGST (Integrated GST) or CGST (Central GST) or SGST/ UTGST (State/ Union Territory GST) and in few items additional cess. IGST is leviable in case of interstate supply and CGST plus SGST/ UTGST is applicable in case of intra-state supply. In either situation of interstate or intrastate supply rate of tax is same e.g. if for particular supply IGST rate is 18%, then on same supply CGST and SGST/ UTGST rate is 9% each.

18. INTRA STATE/ INTERSTATE SUPPLY

Classification of any supply as interstate or intrastate depends upon the location of supplier and place of supply (not the place of receiver). Place of supply is a defined term for goods and services and has specific provisions in different situations.

19. E-WAY BILL – MOVEMENT OF GOODS

In GST, movement of goods whether for supply or for job work or even in case of no supply, require e-way bill (portal generated) to be accompanied with goods. This requirement is limited to situation when either of the party in movement of goods is registered person. In absence of e-way bill, invoice copy along with goods in transit; such person is liable for heavy penalty and even may be subject to confiscation. Goods moved not for supply need to be accompanied by specified delivery challan, in lieu of tax invoice.

20. COMPOSITE LEVY SCHEME

GST Act requires multiple compliances in relation to tax payment, tax return filing, invoicing etc. However, the dealers that work at a smaller level may have a limited turnover and may not have the required resources to comply with the complicated provisions. Thus, the composition scheme has been introduced to minimize the burden of tax compliance for small taxpayers. The dealer who opts for Composition Scheme *u/s* 10 of CGST Act is known as a Composite dealer.

20.1 As per Composition Levy Scheme

Certain categories of person registered under GST, whose aggregate turnover in the preceding financial year did not exceed Rs. 1.00 crore, may opt to pay, in lieu of the tax payable by him, an amount calculated at such rate as may be prescribed, but not exceeding:

a. One per cent of the turnover in State or turnover in Union territory in case of a manufacturer,

b. Two and a half per cent of the turnover in State or turnover in Union territory in case of persons engaged in making supplies referred to in Clause (b) of paragraph 6 of Schedule II, and

c. Half per cent of the turnover in State or turnover in Union territory in case of other suppliers, subject to such conditions and restrictions as may be prescribed.

20.2 Benefits of Composition Scheme

3. The dealer has to pay a fixed percentage of turnovers as tax and need not worry about complicated tax calculations.

4. They have to file quarterly returns and not monthly returns like a normal taxpayer.

20.3 Limitations under Composition Scheme

1. The dealer cannot go for inter-state supply of goods.

2. The dealer is not entitled to Input Tax Credit.

3. The dealer cannot charge GST in their invoice and thus cannot recover tax from buyer.

20.4 Basic Points in Respect of Eligibility of Composition Scheme

1. Turnover of all businesses with same PAN has to be added up to calculate turnover for the purpose of composition scheme.

2. Only manufacturers of goods, dealers, and restaurants (not serving alcohol) can opt for composition scheme

3. As per notification dated 01/ 01/ 2018, turnover in case of traders has been defined as “Turnover of Taxable Supplies of Goods”.

4. Service Providers are not eligible for Composition Scheme except those who provide 10 per cent services from their annual turnover.

5. Rates under composition scheme are applicable only to sales of a composition dealer and not for paying tax under Reverse Charge.

6. A dealer opting for Composition Scheme cannot avail Input tax Credit against purchases made under Goods and Services Tax.

7. The dealer under Composition Scheme has to issue Bill of Supply and cannot issue tax invoice.

8. A Composition dealer cannot collect composition tax from buyers.
9. An annual declaration has to be given by the dealers who wish to opt for composition scheme for a particular Financial Year and that too at the beginning of the year.

21. GSTR-9, THE ANNUAL RETURN OF GST

21.1 The Government has notified GSTR 9, which is basically an Annual Return of GST, which will help the tax authorities in detecting tax evasion under the Goods and Services Tax (GST). Taxpayers registered under GST as well as those covered under composition levy scheme have to file this return once a year. GSTR 9 primarily contains details of incoming as well as outgoing supplies under the various types of GST i.e. CGST, IGST, and SGST. GSTR 9 will seek comprehensive details of all inward and outward supplies by a taxpayer to other entities in a financial year, the input tax credit and refunds claimed and the breakup of the taxes paid. At present, only a simplified monthly GSTR 3B form and GSTR 1 form is filled by tax payers, and those do not allow for invoice matching by tax authorities. The Annual Return also acts as a means of checking the validity of monthly and quarterly returns filed throughout the year.

21.2 The Annual return in GSTR 9 has to be filed by 31st of December of the subsequent fiscal year. For example, the annual return for the Financial Year 2018–19 has to be filed by 31st December 2019.

21.3 The Annual Return has to be filed by following 4 classes of persons as prescribed by the GST rules:

- Casual Taxable Person
- Input Service Distributor
- Non-Resident Taxable Person
- People paying TDS under Section 51 of GST Act

21.4 GSTR 9 consists of 4 return types in total, which are;

1. GSTR 9: Regular Taxpayers who file GSTR 1, GSTR 2 and GSTR 3
2. GSTR 9A: Taxpayers registered under composition scheme of GST should be filing this return type
3. GSTR 9B: E-commerce operators have to file this return if they have filed GSTR 8 in the same Financial Year
4. GSTR 9C: Taxpayers with Annual Turnover of more than prescribed limit (presently Rs. 2 crores). These taxpayers have to get their accounts audited.

21.5 As per Section 35(5) of CGST Act, every registered person whose turnover during the financial year exceeds prescribed limit (Rs. 2 cr.) shall get his accounts audited by a chartered accountant or a cost accountant and shall submit a copy of the audited annual accounts, the reconciliation statement under sub-section (2) of Section 44 which is called GSTR9-C and such other documents in such form and manner as may be prescribed. Hence, requirement of GST Audit *u/s* 5)35) would arise only if prescribed limit of turnover exceeds Rs. 2 cr. and certified reconciliation statement-GSTR-9C shall be required to be submitted. On the other hand, GSTR-9 is an Annual return which is required to be filed by every registered person irrespective of threshold limit of turnover.

22. HOW THE GSTR-9 COULD BENEFIT IN INCOME-TAX PROCEEDINGS

22.1 GSTR-9 Contains Details Such as

i. Applicability of Statutory Audit or Not. If yes, Auditor details for the tax Period.

ii. Details of Expenditure incurred with bifurcation in the taxable value of goods and/ or services taken.

iii. Details of all the supplies made in a tax year differentiating between goods and/ or services.

iv. Return Reconciliation Statement where the system will auto-reconcile the transactions and will determine tax liability payable against the tax actually paid.

v. Breakup of gross profit, profit after tax and net profit for the tax year for which return is filed.

22.2 The information available in GSTR-9 could be cross-verified with the information filed in Income-tax return. The AO could also use data analytics to identify any underlying attempt by the taxpayer to understate sales turnover. Both GST and Income-tax Returns are to be linked to the Permanent Account Number or the PAN Card of the taxpayer. Hence, frictionless exchange of relevant information between the indirect and direct tax authorities could increase transparent tax compliance by a significant number. This could also equip the AO with all the relevant and important information about a company like financial transactions, registration information and direct and indirect tax filings.

22.3 Since, the Annual Return in GSTR 9 has to be filed by 31st December of the subsequent fiscal year; the AO shall have the benefit of going through the GSTR-9 as well at the time of scrutiny assessments. Hence, different transactions reported in GSTR-9 could be examined and cross verified with the respective income-tax returns to verify whether there could be any possible tax evasion arising out of discrepancies between the two annual tax returns filed under Income-tax provisions and GST provisions.

22.4 The data obtained from GST filings may be used to track those who could be escaping out of income-tax net. The data obtained through GST reporting could be correlated with the income-tax filings. Unlike the earlier tax regime, GST leaves a trail, especially for business of size, and it becomes hard to underreport income or exaggerate expenses. Technically, it is possible to use GST data to draw linkage with the income-tax data through the common data set with the help of analytics. Currently, the GSTN and income-tax department already have the data to carry out the risk analysis where outliers in terms of industry average of tax payments is scrutinized and those not paying or under reporting company revenues could be questioned.

22.5 A sudden jump in the turnover of a manufacturing unit using specialized raw materials may raise a red flag for further examination by the AO. Earlier there was no trail available for the raw materials purchased and goods supplied. If the GST return shows a big jump in turnover compared to the previous years due to increasing formalization of the economy, this could be a potential indicator for questioning the past year's returns as well. The suppression of turnover in the earlier years can be identified in the new GST regime by comparing the turnover in the IT return with the GST annual return.

22.6 In this regard, it is pertinent to note that as per income-tax provisions each assessee is required to file only one return of income from all sources and for all its business operations. However, as per legal provisions of Section 44(1) of CGST Act, every registered person shall be required to file GSTR-9. Hence, if a Taxpayer has obtained multiple GST Registrations whether in one state or more than one state, it shall be

treated as a distinct person in respect of each such registration as per Section 4)25) of CGST Act. Hence, GSTR-9 is required to be filed separately for each such GSTIN. Hence, there could be multiple GSTR-9 filed by any particular Income-tax assessee. It is, therefore, imperative that the AO may verify whether a particular assessee has obtained multiple GSTIN and in such cases all the GSTRs-9 filed by him for such multiple GSTINs may be verified to arrive at the composite transactions of the assessee for comparison and verification with the Income-tax Return.

23. IMPORTANT SITES AND WEB LINKS

i. CBITC–www.cbic.gov.in

ii. GST portal–www.gst.gov.in

iii. E way bill portal–ewaybill.nic.in

CHAPTER

13

Tax Investigation of Bitcoin/ Cryptocurrency Transactions

1.1 The virtual currencies market has seen a steady growth in the last few years. Most of the investors of virtual currencies are High Net Worth Individuals who are suspected to have invested their unaccounted income in Bitcoins/ Virtual currencies. As the sector remains unregulated, it is highly possible that unaccounted investment and income generated out of it is used for evasion of taxes.

1.2 Virtual Currency is a digital currency in which encryption techniques are used to regulate the generation of units of currency and verify the transfer of funds, operating independently of a central bank. It can be digitally traded as a medium of exchange. The best known crypto currency is Bitcoin. Other popular crypto currencies are Ether, Ripple, Bitcoingold, Bitcoincash, IOTA, WCT, EQT, BIS, JINN, ZEC, XCP, BAT, CPC, XMR, SIAcoin, etc.

1.3 Investment in Bitcoins has gained momentum due to the anonymity provided by the same. The public key of the Bitcoin holder is open and the corresponding ledger is accessible to everyone. However, the identity of the owner of the public key holding Bitcoins remains anonymous. Due to this, the unaccounted income earned by the high net worth individuals is being routed through the investments in Bitcoins and other virtual currencies.

1.4 The Bitcoins transactions remain unregulated till date. RBI in its Press release dated 24.12.2013 had stated that there have been several media reports of the usage of VCs, including Bitcoins, for illicit and illegal activities in several jurisdictions. The absence of information of counterparties in such peer-to-peer anonymous/ pseudonymous systems could subject the users to unintentional breaches of anti-money laundering and combating the financing of terrorism (AML/ CFT) laws.

1.5 This regulatory arbitrage has helped individuals to invest unaccounted income in Bitcoins and Virtual currencies. The unprecedented high profits earned through these activities have also not been offered for taxation by taking the leverage of regulatory arbitrage.

2. TAXATION OF CRYPTO/ DIGITAL/ VIRTUAL CURRENCIES TRANSACTIONS INCLUDING BITCOINS

2.1 Digital/ Crypto/ Virtual Currency is not Recognised as currency by RBI. As per RBI creation, trading or usages of Virtual Currencies as a medium for payment are not authorized by any central bank or monetary authority. There are no regulatory approvals, authorization or authentication obtained by these Virtual currency entities. RBI has also clarified that they have not given any license or authorization to any entities to operate such scheme or deal with Bitcoin and any other Virtual/ Digital Currency and that investors/ traders dealing with Virtual Currencies will be doing so at their own risk.

2.2 RBI has also outlined some of the risks of Virtual/ Digital Currencies which are listed as under:

1. Digital/ Virtual currency being stored in electronic wallet, are prone to losses arising out of hacking, loss of password, compromise of access credentials, malware attack etc.
2. Since Virtual Currency wallets are not created by any authorized central registry or agency, the loss of e-wallet could result in the permanent loss of the Virtual currencies held by individuals.
3. As payments in Virtual currencies takes place on peer to peer basis without any authorized central agency, there is no established framework for recourse to customer problems/ disputes/ charge backs.
4. There is no underlying or backing of any asset for virtual currency.
5. Users are exposed to potential losses on account of huge volatility in value.
6. It has been reported that usage of digital currencies is largely for illicit and illegal activities.
7. The absence of information of counter parties in such peer to peer anonymous/ pseudonymous systems could subject the users to unintentional breaches of anti-money laundering and combating the terrorism laws.

2.3 Since the RBI has not Recognised Virtual/ Digital Currency as approved currency, the Bitcoin transactions do not come under the purview of Foreign Exchange transactions in India regulated under Foreign Exchange Management Act, 1999. Section 5 of FEMA,1999 which provides for buying and selling of foreign exchanges by Indian residents will not be applicable for Bitcoin or Virtual/ Digital Currency transactions. Therefore, the Virtual/ Crypto/ Digital Currency transactions cannot be construed as currency trade regulated by RBI.

2.4 The investment/ trading in Virtual/ Digital/ Crypto Currency transactions also do not come under purview of securities/ commodities as provided under Securities Contract Regulation Act,1956 (as amended in 2017). Therefore, trading in Crypto/ Digital/ Virtual Currencies do not enjoy the benefit of a security/ derivative/ top exchange as provided under Securities Contract Regulation Act. Therefore, the tax benefits available to the stocks, shares & Mutual Funds or commodities in the approved stock exchanges is not allowed for trading of Crypto/ Digital/ Virtual Currencies including Bitcoins on Bitcoin exchanges in India or abroad.

2.5 In view of the above, the Virtual/ Digital/ Crypto Currency transactions cannot be termed as currency transactions or securities trading or commodity trading and the same would be treated as Capital Asset. Section 2(14) of I.T. Act 1961 defines capital asset as property of any kind held by an assessee, whether or not connected with his business or profession. There are different definitions of property given in different act as per their uses and needs. But in the most important act which exclusively talks about the property and rights related to property,

Transfer of Property Act 1882 has no definite definition of the term property. But it is defined in some other acts as per their use and need. Those definitions are as follows:

2.6 Section 2(c) of the Benami Transactions (Prohibition) Act, 1988 defines property as, "Property" means property of any kind, whether movable or immovable, tangible or intangible, and includes any right or interest in such property. Section 2 (11) of the Sale of Good Act, 1930 defines property as, "Property" means the general property in goods, and not merely a special property. Section 3 (36) of the General Clauses Act defines movable property as, 'Movable property' shall mean property of every description, except immovable property. "Section 2 (9) of the Registration Act, 1908 defines property as, 'Movable property' includes standing timber, growing crops and grass, fruit upon and juice in trees, and property of every other description, except immovable property." Section 22 of IPC defines property as, the words "movable property" is intended to include corporeal property of every description, except land and things attached to the earth or permanently fastened to anything, which is attached to the earth. Things attached to the land may become moveable property by severance from the earth. For example, Cart–loaded of earth, or stones quarried and carried away from the land become movable property.

2.7 From the above, it is clear that, in respect of transactions in Virtual/ Digital/ Crypto currencies could be construed as intangible property and therefore the gain or profit thereof has to be taxed under Capital Gains or Business Income depending on the type business carried out by Virtual/ Digital/ Crypto Currency operator and nature of his transactions.

2.8 In order to understand the tax implications of cryptocurrencies in India, the following points need to be understood under the context of the Income-tax Act:

1. **Business Income**: These are the profits and gains received from any business or profession carried on by the tax payer at any time during the Financial Year. It includes 'any' compensation received or other payment due to be received. Further, the compensation may be received in Cash or Kind.
2. **Capital Gains**: It means any income which has been derived from a 'Capital Asset' (whether movable or immovable).
3. **Capital Asset**: It means property of any kind held by the taxpayer, whether or not connected with his business or profession.

However, this does not include any Stock in Trade.

Note: Since the cryptocurrencies have not yet been declared as legal tender by the Reserve Bank of India, these cannot be considered as legal tender (cash) and shall be considered as an asset. With a general understanding of the above terms, we move on to understand how cryptocurrencies would be taxed under different scenarios:

3. SCENARIO 1: WHEN A PERSON RECEIVES CRYPTOCURRENCY AS PAYMENT FOR RENDERING GOODS OR SERVICES

3.1 If a provider of goods or services receives any payment by cryptocurrency, then, the fair market value of the cryptocurrency received as consideration for rendering the goods or services will be considered as the consideration (that is the sale amount). Hence, the difference between the Fair Market Value of the cryptocurrency and the cost of provision of goods or services will be treated as Business Income in the hands of the taxpayer and the resultant Business Income will be charged to tax at the applicable slab rate.

Let us take the following example to understand the above more clearly:

Mr. A provides services for which he agrees to receive 2 Bitcoins. For simplicity purpose, assume the cost of provision of service as Rs. 5,00,000/- and the Fair Market Value of 1 Bitcoin = Rs. 5,50,000/-. Hence, by applying simple mathematics we can conclude that the total consideration for the services rendered is Rs. 11,00,000/- (5,50,000*2) and the profit in such a transaction is consideration received (Rs.11,00,000) minus cost of services (Rs. 5,00,000) resulting in profit of Rs.6,00,000/-

3.2 Continuation of Scenario 1: The person receiving cryptocurrency as consideration sells the cryptocurrency

Now as soon as the person receives the cryptocurrency as consideration, it becomes his capital asset under the assumption that it is not Stock in Trade (which is discussed later). Therefore, as and when the person sells the cryptocurrency, the resultant difference between the Fair Market Value on the date of receipt of cryptocurrency (from the provision of goods or services) and the date of sale of cryptocurrency will be treated as Capital Gain.

Further, if the cryptocurrency is held for 36 months or less, it will be treated as Short Term Capital Gain. If it is held for more than 36 months it will be treated as Long Term Capital Gain.

While computing Long Term Capital Gain, the taxpayer will get the benefit of indexation.

The bifurcation of Short Term Capital Gain and Long-Term Capital Gain is important since the Short-Term Capital Gains are taxed at Slab Rates and Long-Term Capital Gains are taxed @ 20%.

Let us continue the example taken in Scenario 1:

Suppose the bitcoins received by Mr. A is sold by him @ Rs. 5,75,000/- per Bitcoin then the value of the consideration that will be received by Mr. A is Rs. 11,50,000/-. Hence, the Capital Gains would be Rs. 50,000/- (11,50,000 - 11,00,000) and depending on the period of holding of the cryptocurrency, it will be taxed as Short-Term Capital Gain or Long-Term Capital Gain

3.3 Scenario 2: A person paying consideration by cryptocurrency for receiving any goods or services

If a person availing any goods or currency pays consideration in the form of cryptocurrency, then in such a case there will be aspects which will need to be considered:

i. Capital Gains

ii. Amount (Quantification) of the expense

Capital Gains: The Capital Gains will be determined in the same manner as discussed in 'continuation of scenario 1' and will be taxed accordingly. However, in this case the relevant dates for determination of period of holding shall be the date of acquisition of the currency and the date of payment

Amount of Expense: The amount of expense shall be the Fair Market Value of the cryptocurrency on the date of payment

Let us take the following example to understand the above clearly:

Mr. A avails goods worth Rs. 11,50,000/- the payment for which is discharged by paying 2 Bitcoins (5,75,000 * 2). Assuming the cost of acquisition of 2 Bitcoins to be Rs. 10,00,000/- (5,00,000 * 2), the resultant Capital Gain will be Rs. 1,50,000/- and will be taxed as Short-Term Capital Gain or Long-Term Capital Gain depending on the period of holding.

The amount of expenditure will be the Fair Market Value of the Bitcoins that is Rs. 11,50,000/-

3.4 Scenario 3: A person Investing/ Trading in cryptocurrency

This is the simplest to understand. However, the important aspect to be considered is whether the activity is to be considered as Investment or Trading.

If the activity is considered as Investment the difference between the sale price and purchase price will be treated as Capital Gains (the treatment will be as discussed earlier) and on the

contrary if the activity is considered as Trading, the difference will be treated as Business Income irrespective of the period of holding.

Determining whether the difference will be considered as Capital Gains or Business Income will depend solely upon the intention of the person at the time of acquisition of the cryptocurrency.

4. DIFFERENT MODES OF TAX EVASION IN BITCOINS/ CRYPTOCURRENCIES TRANSACTION

4.1 Unaccounted Investment in Bitcoins

a. Purchasing of Bitcoins: Here unaccounted income earned through various other activities is invested by individuals in the Bitcoins directly. The cash deposited in various bank accounts is then transferred to the registered exchanges and Bitcoins are purchased. When these Bitcoins are sold, the proceeds are received through the banking channels. This has become a convenient way of money laundering due to the anonymity provided by the same.

b. Investment in Foreign Exchanges: Unaccounted income earned in India is transferred out of the India through illegal channels and the same amount is travelling for purchasing of the Bitcoins from the exchanges and websites registered out of the India. Investment in Bitcoins out of India through unauthorized transfer of money outside the borders involve violation of FEMA and possible violation of Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 having an asset (including financial interest in any entity) located outside India, held by the assessee in his name or in respect of which he is a beneficial owner, and he has no explanation about the source of investment in such asset or the explanation given by him is in the opinion of the Assessing Officer unsatisfactory.

These Bitcoins purchased out of India by transfer of money through illegal channels are then transferred to the public key of the real beneficiary owner. As the identity of the pubic key holder remains anonymous and asset is present in the virtual world, it is highly possible that these transactions have evaded taxation in India.

c. Cash Purchase of Bitcoins in India: Local Bitcoins is a P2P exchange platform. Buyers and sellers agree on trade terms and Local Bitcoins is used as Escrow. Local Bitcoins is available in nearly every country. Local Bitcoins does not impose any pricing limits on its users. Users are free to decide their own prices and limits. The payment methods available to buyers are through banking channels as well as cash deals. Local Bitcoins does not require any ID verification or any personal information besides an e-mail id which is required to sign up. Platforms like these are used by individuals to buy and sell Bitcoins in cash.

4.2 Source of Investment is Explained but Income is Not Offered to Tax

During preliminary verification it is seen that in many cases even though the source of the investment is explained but income is not being offered to tax. The anonymity provided by Crypto currency transactions has helped individuals to earn unaccounted income. In one of the cases in Bangalore during verification *u/s* 131, it was found that, a college dropout boy had taken few lacs from his parents for making investment in Crypto currencies and has earned income of Rs. 1.5 Cr in a very short span of time. This income had escaped taxation.

4.3 Investment Made in Websites and Exchanges Registered Outside India and Income Earned Out of it

Till late 2017, Indian Bitcoin exchanges allowed trading only in Bitcoins. Indian exchanges like Koinex.com, Coindelta.com have recently started trading in crypto currencies other than Bitcoins. Therefore, to trade in other cryptocurrencies, Indian investors/ traders had to invest from exchanges/ websites registered out of India. There are hundreds of such websites. However, most popular websites among the Indian investors/ traders are as below:

1. BITTREX.com
2. POLONIEX.com
3. COINBASE.com
4. BITFINEX.com
5. CEX.io
6. CRYPTOPIA.com

On these websites, there are two options:

a. Purchase of crypto currencies by making payment in Bitcoins. Here, investor/ trader can purchase Bitcoins in India through various exchanges like Zebpay, Unocoin and same is transferred to an account maintained with websites registered out of India. Thereafter by making payment in Bitcoin, other cryptocurrencies are purchased.

b. Purchase of crypto currencies by making payment through credit cards. Here, investor/ trader can make payment by his Credit card for purchase of Bitcoin or other crypto currency.

Many investors/ traders prefer purchase of Bitcoins out of India as generally, rates of Indian exchanges are found to be higher than the International market as there are more buyers than sellers in India. However, these foreign based websites do not allow the conversion of the crypto currencies into Fiat currency. Therefore, if an investor/ trader wants to convert his crypto currency (other than BITCOINS) into fiat currency, he first converts all his other crypto currency to BITCOINS from any other foreign based website or cryptocurrency exchange and converts such BITCOINS in INR by sale at "Bitcoin Exchanges" in India.

Income earned from such sales of Bitcoins in India n exchanges needs to be identified from the data collected. Credit card transactions of the assesse have to be collected to identify such transactions. In statement on oath *u/s* 131 of I.T. Act, transaction details of purchase/ sale of cryptocurrencies needs to collected as transactions made on websites/ exchanges registered out of India will not reflect in the data collected from Indian exchanges.

4.4 Profits Generated from Conversion of One Crypto Currency to Another Crypto Currency are not Offered to Tax

Profit margins in other cryptocurrencies are significantly higher as compared to Bitcoin due to their low base price. Therefore, investors/ traders convert their Bitcoins in other cryptocurrency to earn higher profits. Investors/ Traders are allowed to trade in various crypto currencies through the websites based outside India. These transactions are basically in the nature of "Crypto to Crypto" transactions.

These exchanges/ websites like Bittrex.com mentioned above, allow the users to trade from one crypto currency to another crypto currency. Investors earn profit on conversion of one cryptocurrency into another cryptocurrency. This cryptocurrency is again converted into another cryptocurrency. At each conversion investor/ trader makes profits and hence profits have to be calculated on accrual of income. For this, reference price of Bitcoin at the time of conversion needs be taken to convert it into INR and calculate his total profits. For calculating realized profits from crypto to crypto transactions,

use of websites such as cointracking.info can be made. These websites imports data of all the transactions of client from various websites such as Btfinex.com, Bittrex.com etc. They also allow user to upload transaction data in excel format. After uploading of all cryptocurrency transaction data, they capture cost of the cryptocurrency at the time of transaction and arrive at realized and unrealized profits. It also gives profit and loss account of the user.

During verification of Bitcoin investors *u/s* 131 in Bangalore, this modus is confirmed from various individuals and profits on each conversion is calculated by taking reference price of Bitcoins for arriving at tax liability on accrual of income.

4.5 Cryptocurrencies are Purchased in Initial Coin Offering (ICO) on Websites Registered Abroad and Sold in India are Not Offered to Tax

"Initial Coin offering" (ICO) is similar to "Initial Public Offering" (IPO). Before the launch of any new Crypto currency, promoters come out with ICO to collect investments. These ICO's are advertised on various cryptocurrency platforms. The price of new crypto currency to be launched is also decided prior to launch of ICO. In these ICO's investors have to make investment in the form of Bitcoins. After the launch of the said new crypto currency, it is credited to the investors account in proportion to his investments.

One person in Bangalore was found to be trading in various crypto currencies other than BITCOIN through the foreign based websites like BITTREX.com, POLONIEX.com, COINBASE.com, BITFINEX.com, etc. It is found that he has made substantial profits from the trading in such crypto currencies. He is found to be holding stock of various crypto currencies valued at Rs. 400 crores as on 31.12.2017. He had started with an initial investment of Rs. 2 Lakhs in December 2015. He participated in the "Initial Coin Offering" of IOTA cryptocurrency and bought 0.5% of its global supply. The value of his investment in IOTA multiplied several times over a period of two years. He has sold a portion of the said investment and holds on to a substantial portion of it as on date. His gain on conversion of one crypto currency to another crypto currency and the subsequent sale thereof is being worked out.

4.6 Income Generated from Arbitrage Trading on Indian as Well as Foreign Based Exchanges is not Offered to Tax

Arbitrage is the simultaneous purchase and sale of an asset to profit from a difference in the price between exchanges. It is a trade that profits by exploiting the price differences of identical or similar financial instruments on different markets or in different forms. As mentioned above, there is always price difference between prices of Bitcoins and other crypto currencies in International market and domestic market. In fact, there is always price difference in various exchanges in India itself. Traders buy cryptocurrency from international websites or exchanges by making payments in credit cards and sale immediately in Indian exchanges. In India itself, traders make profits by taking advantage of price difference between various Indian exchanges. During verification *u/s* 131, it is found that such profits are not being offered to tax.

4.7 Income Generated from Peer to Peer Sale of Bitcoins (Either in India or Outside) are Not Offered to Tax

Bitcoin transactions are based on Blockchain technology, wherein there is no need of any intermediary for transactions of Bitcoins. Thus, any peer to peer transfer of Bitcoins by exchange of cash, is not captured in data collected from exchanges under survey operation. Such peer to peer transactions also takes place in exchange

of crypto currencies with Bitcoins. Therefore, the investigating officer has to confront the assessee to confirm such transactions. By placing assessee's public id on BLOCKCHAIN.INFO, his whole transaction ledger of Bitcoins can be aggregated and such transactions can be confirmed from the assessee for gains transaction-wise.

Such transaction was found from one individual in Bangalore, wherein he has sold his crypto currency to an individual in Germany and received payment on his Blockchain account in Bitcoins. There are various online groups, Telegram (app) groups, groups of people and individuals who have credibility in crypto currency market, work as ESCROW for enabling such transactions.

4.8 Income Generated from Sale of Bitcoins on Online Platforms like Localbitcoin.com (which Enable Cash Purchase and Sale of Bitcoins) are Not being Offered to Tax in India

Local Bitcoins is a P2P exchange platform. Buyers and sellers agree on trade terms and LocalBitCoins is used as Escrow. Local Bitcoins is available in nearly every country. Local Bitcoins does not impose any pricing limits on its users. Users are free to decide their own prices and limits. The payment methods available to buyers are through banking channels as well as cash deals. Local Bitcoins does not require any ID verification or any personal information besides an e-mail id which is required to sign up. Platforms like these are used by individuals to buy and sell Bitcoins in cash.

4.9 Income Generated from Mining of Bitcoins are Not Offered to Tax

Bitcoin mining has become a profitable industry. Bitcoins can be mined by making individual investment in mining of the Bitcoins. Investment in Bitcoin mining can also be made by investing in Bitcoin mining companies. These companies then distribute the rewards to the investors in proportion of their investments. The rewards received have not been offered for taxation as mining companies are registered out of India. We have observed undisclosed investment in mining companies in few cases in Bangalore.

4.10 Income Generated from Investment in Multi-Level Marketing Companies Dealing in Various Crypto Currencies are Not Offered to Tax

Multi-Level Marketing companies offer investments by the individuals in the companies. These companies are collecting investments from various individuals in Bitcoins and virtual currencies. By following the same *modus operandi* of Multilevel Marketing companies, they are giving periodic rewards to the investors. The investment generated by these MLM companies is then invested in the mining of the Bitcoins and Virtual Currencies. The returns generated by both, individuals and MLM companies are not being offered to tax. This mode was observed in a search case conducted in Bangalore.

4.11 Bitcoins Received in Lieu of Services Rendered Outside India are Not Offered to Tax

Bitcoins are being received in lieu of services rendered outside India. One software engineer in Bangalore has stated during examination *u/s* 131 that he rendered some services to a company situated outside India by working from home for which he was paid compensation in Bitcoins. It was found that the said compensation received in Bitcoins was not offered for tax in his returns of income filed. The consideration for services rendered both in India and abroad could be settled through Bitcoins and other Digital/ Crypto Currencies and such arrangements could be discovered only through identification of Bitcoin transactions.

4.12 Bitcoins Received in Lieu of Exports Made are Not Offered to Tax

Bitcoins are being received in lieu of the exports of goods and services. During examination of one person in Madurai, it was found that he had received BITCOINS valuing Rs. 4 crores for rendering web designing services to a client situated outside India. This export proceeds received in Bitcoins is found to be recorded in his books of accounts. However, no RBI approval has been taken for receipt of export proceeds in crypto currency in his Bitcoin wallet account. Such transactions would not qualify as export proceeds in the absence of RBI approval or receipt in approved currencies of RBI. Bitcoin being illegitimate currency for the purpose of receipt of export proceeds, the case needs examination from FEMA angle.

4.13 Bitcoins Received as Gifts from Non-Residents Indians are Not Offered to Tax

Nonresident Indians as well as Indians are giving gifts and donations in the form of Bitcoins other cryptocurrencies. Such transactions are outside the ambit of regulatory oversight of Banks and also cross border transaction regulations. Therefore, the same needs examination from tax angle as well as FEMA angle.

4.14 Bitcoins Purchased Abroad while Working on Site Assignments are Sold in India and Not Offered to Tax

It is seen that Indians while working on site assignments abroad are purchasing Bitcoins there as prices of Bitcoins are relatively cheaper than Indian market. After returning in India, they just transfer it to their public key and sell it in Bitcoin exchanges in India.

4.15 Bitcoins are being Given on Interest by Individuals and Interest Income is Not Offered to Tax

During a verification of an individual case *u/s* 131 in Bangalore, it is found that are persons are even lending Bitcoins and are receiving interest on that. The original investment and interest earned was not offered to tax.

4.16 In the Transaction Data Collected, in Many Individual's Cases, there are No Purchases Reported, However Sales are Reported

In such a scenario, there are following possibilities:

a. He has purchased from one Indian Exchange and sold on other Indian Exchange (Arbitrage trading)

b. He has purchased from foreign Exchange and sold on Indian Exchange.

c. He has converted his Bitcoins in other crypto currencies on websites/ exchanges registered out of India. Such case is found in Bangalore wherein as per his transaction data on Zebpay, he has sold Bitcoins of around worth Rs 1.5 Cr, however, he has converted his Bitcoins in other Cryptocurrencies on other websites out of India and has earned a profit of around Rs. 25 Cr on such crypto-to-crypto conversions.

d. He has purchased in cash from peer to peer transactions and sold on Exchanges.

5. TECHNICAL ASPECTS OF CRYPTOCURRENCY AND BLOCKCHAIN TRANSACTIONS

5.1 Crypto currency is a digital currency in which encryption techniques are used to regulate the generation of units of currency and verify

the transfer of funds, operating independently of a central bank. It can be digitally traded as a medium of exchange. The best known crypto currency is Bitcoin. Other popular crypto currencies are Litecoin, Ethereum, Dash, Zcash, Monero etc.

5.2 Bitcoins are created through Block chain mining. The creator of Bitcoins, Satoshi Nakamoto has declared that there will be total 21 Million Bitcoins. The value of Bitcoins comes from the economic principle of demand and supply. Thus, as Bitcoins are going to be limited, the artificial scarcity created is ensuring its value. As on date, 12.5 Bitcoins are being created every 10 minutes by the process of mining. For every 2,10,000 authenticated blocks (about once every 4 years) the number of Bitcoins mined will be halved. This halving in the rate of Bitcoins mined per Block will go on for every four years until 2140 A.D.

6. TECHNOLOGY

Crypto currency is based on the science of cryptography and Blockchain technology. In order to understand how cryptocurrency works, we need to understand a few basic concepts.

6.1 Public Ledgers

All confirmed transactions from the start of a cryptocurrency's creation are stored in a public ledger. The ides of the coin owners are encrypted, and the system uses other cryptographic techniques to ensure the legitimacy of record keeping. The ledger ensures that corresponding "digital wallets" can calculate an accurate spendable balance. Also, new transactions can be checked to ensure that each transaction uses only coins currently owned by the spender. Bitcoin calls this public ledger a "transaction block chain".

6.2 Transactions

A transfer of funds between two digital wallets is called a transaction. That transaction gets submitted to a public ledger and awaits confirmation. When a transaction is made, wallets use an encrypted electronic signature (an encrypted piece of data called a cryptographic signature) to provide a mathematical proof that the transaction is coming from the owner of the wallet. The confirmation process takes a bit of time average ten minutes for bitcoin while "miners" mine to confirm transactions and add them to the public ledger.

6.3 Mining

In simple terms, mining is the process of confirming transactions and adding them to a public ledger. In order to add a transaction to the ledger, the "miner" must solve an increasingly-complex computational problem, sort of like a complex mathematical puzzle. Mining is open source, so anyone can confirm the transaction. The first "miner" to solve the puzzle adds a "block" of transactions to the ledger. The way in which transactions, blocks, and the public blockchain ledger work together ensures that no one individual can easily add or change a block at will. Once a block is added to the ledger, all correlating transactions are permanent and a small transaction fee is added to the miner's wallet along with newly created coins. This process of mining is ensured with reward (The amount of new bitcoin released with each mined block is called the block reward) and fees associated with confirming the transactions. Thus, miners receive two rewards. One, mining creates new Bitcoins for every Block mined. The other reward comes from transaction validation fees. For adding one block to the block chain, miner is rewarded 12.5 newly created Bitcoins. The block reward is halved every 2,10,000 blocks or roughly every 4 years. The difficulty of mining adjusts itself with the aim of keeping the rate of block discovery constant. Thus, if more computational power is employed in mining,

then the difficulty will adjust upwards making mining harder over time. The mining process is what gives value to the coins and is known as a proof-of-work system.

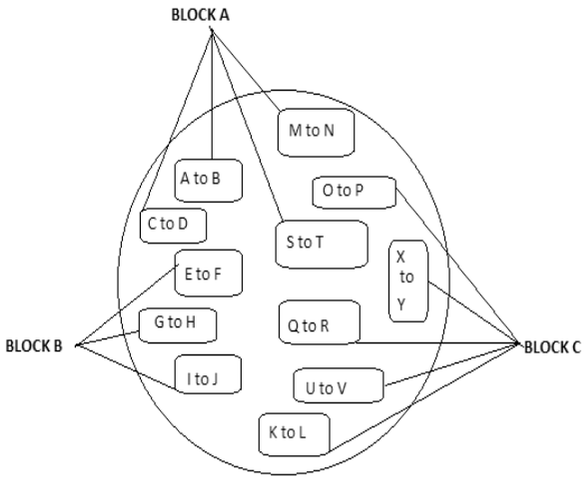
6.4 HOW IT WORKS??

A Bitcoin is created by mining a Block (Block is a collection of data containing the transactions). First Bitcoin is created by mining the first Block (which is called as Genesis Block) in 2009 by Satoshi Nakamoto. Bitcoin is an open source network having public ledger. This public ledger is visible to everyone on the network and can be checked, verified by anyone on the network. A person holding the Bitcoin account has two keys: a Public key and a Private Key. A person's public key shows public ledger of transactions made by him. This public key is unique key for everyone and visible to everyone on the network. Private key is the personal key of digital wallet holder and it has to be kept safe and confidential.

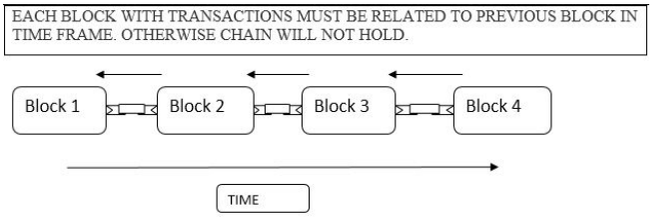
Let's take an example

In Bitcoin network, when A wants to send Bitcoins to B, this transaction is given separate digital ID. This Digital ID of each unit is encrypted to avoid hacking or duplication or any fraud. To transact the Bitcoins, A needs to announce on the network that a particular amount from his account should be deducted and added to B's account. Any transaction that is announced on the network is recorded by the special software in computers called as "nodes". The persons working on network are called as "miners". These miners have to verify and approve the transaction between A and B. They verify the previous transactions of the sender from his public key for verification of the available balance in his account. Miner also verifies digital signature of the sender to confirm the genuineness of the transaction. This transaction is added to the Block.

A Block contains a number of transactions as shown below.



Block is added to the Blockchain by miners after solving complex mathematical problem. The high randomness in the math problem makes it unlikely that two people will solve it at the same time. Typically, it takes around 10 minutes for a Block to get added to the Blockchain.



Thus, after Block is added to the Blockchain, transaction between A and B for transfer of Bitcoins gets completed.

7. ANNEXURE I: MODEL QUESTIONNAIRE

1. Details of the sources of income.
2. Details of the Income-tax returns filed
3. Details of the movable and immovable properties
4. Details of movable and immovable properties in the name of family members.
5. Whether you are dealing in Bitcoins/ other cryptocurrencies?
6. What are other cryptocurrencies you are dealing in

7. Since when you are dealing in cryptocurrencies.
8. What was your source of income for the initial investment?
9. In which Bitcoin/ cryptocurrency exchanges you have accounts. In India as well as abroad. Submit the details.
10. Furnish the details of all the wallets you are using along with their Unique ID/ number.
11. Are you using physical hardware wallet for storing your Bitcoins and other cryptocurrencies? Give the balance as on date along with the public ID/ wallet number on the Blockchain account.
12. Submit the details of all of the public keys/ wallets owned by you and your family members on Blockchain.
13. Submit the details of all of the Unique client ID's/ wallets owned by you and your family members on Bitcoin/ Cryptocurrency exchanges in India as well as abroad.
14. Please state whether you are buying/ selling Bitcoins and other Cryptocurrencies from websites like Poloniex.com, Coinbase.com, Bittrex.com or any other websites registered out of India.
15. What was the mode of payment for making Bitcoin/ cryptocurrency purchase from websites registered out of India.
16. What was the mode of payment for receiving money out of Bitcoin/ cryptocurrency sales from websites registered out of India.
17. Submit the details of total purchase and sales of Bitcoins and other cryptocurrencies from websites registered out of India.
18. Furnish the details of credit card transactions for the past 3 financial years.
19. Please state whether you are buying/ selling Bitcoins and other Cryptocurrencies from LocalBitcoins.com. If yes, what was the mode of the payment made/ received? Submit the details.
20. Please state whether you are buying/ selling Bitcoins and other Cryptocurrencies in cash by making peer to peer transfer? If yes submit the details of payments made/ received. Also provide details of the buyer and seller along with his public ID on Blockchain/ wallet number.
21. Please state whether you are buying/ selling Bitcoins and other Cryptocurrencies in cash from any platform? Submit the details of transfer along with the details of the platform.

    Whether you have invested in mining of Bitcoins or any other Cryptocurrency? If yes, submit the following details.

    a. Whether you yourself is involved in mining by investing in own physical setup
    b. Whether you are have invested in cloud mining, hash mining
    c. Details of the total investment in mining, Financial Year wise
    d. Details of reward fees earned by mining of Bitcoins and other cryptocurrencies, Financial Year wise
    e. Details of the mining companies you have invested into along with the details of reward fees earned financial year wise.
    f. Furnish the detailed ledger of profits earned from mining of Bitcoins and other crypto currencies.
22. Details of investment/ sales of Bitcoins and other Cryptocurrencies in India and abroad during 8.11.2016 to 31.12.2016.
23. Have you received any Bitcoins/ cryptocurrency in lieu of any sales made/ services rendered within India? Please furnish the details of such transactions along with the details of the person making such payments and his wallet/ blockchain public ID details.

24. Have you received any Bitcoins/ cryptocurrency in lieu of any sales made/ services rendered/ exports made outside India? Please furnish the details of such transactions along with the details of the person making such payments and his wallet/ blockchain public ID details.

25. Please state whether you have offered income from Sale of Bitcoins or any other Cryptocurrency, in any of the previous financial years.

26. Please furnish the details of your transactions in Cryptocurrency financial year-wise, furnish the details in following format.\

27. Whether you have offered profits generated out of transactions in Cryptocurrency for taxation, in any year. Submit the details.

Sr. No.	Currency invested	Initial Amount invested	Amount invested date-wise	Amount withdrawn date wise	Total profits earned year-wise	Total balance as on date in INR

8. CASE STUDY

1. Nine Bitcoin Exchanges/ dealers located across the country were covered as part of All India Operation *u/s* 133A of the Income-tax Act, 1961 on 13/ 12/ 2017 conducted by the Investigation Directorate Bangalore.

2. Details of the transactions, *viz.*, the value of Bitcoins bought, value of Bitcoins sold, the Public key of the wallet in which the bitcoins are kept, date of the transactions, etc. have been collected by the Survey teams from the servers of the respective exchanges. Details of the Investors/ Traders have been obtained from the KYC documents collected by the Exchanges.

3. The total volume of transactions and the number of registered users, as found during the course of survey are as under:

Registered Users	Active Users	Total Buy in Rs.	Total Sale in Rs.	TOTAL VOLUME (in Rs.)
21,08,056	471562	11061,03,46,205.	10739,16,37,872	21800,19,84,078

4. Based on the data collected, summons *u/s* 131 were issued to the top Bitcoin/ Cryptocurrency investors pertaining to the jurisdiction of the Investigation Directorate Bangalore. One of the such investor is Mr ABC.

5. Mr ABC is a B.E. graduate and aged about 31 years. After graduating from engineering college, he was doing his Internet Marketing business from home. He started investing in the Bitcoins and other cryptocurrencies in the FY 2015–16. The source of his initial investment was his earnings from his Internet Marketing Business. He also pre-maturely closed his Insurance policies, availed Gold Loan and Credit Card Loan. His transaction details collected as per data collected from Indian exchanges are as below:

Exchange	2014–15 Buy & Sale	2015–16 Buy & Sale	2016–17 Buy & Sale	2017–18 Buy & Sale	Total Buy & Sale
Unocoin	2,69,070 & Nil	2,18,147 & Nil	5,01,000 & 5,94,333	0 & 19,67,290	9,88,217 & 25,61,623
Zebpay	Nil	7,65,528 & Nil	574363 &7932658	Nil & 9438946	1339891 & 17371604

From the above table it is seen that, each year his volume of transactions from Exchanges registered in India are in few lakhs only. However, he is also having accounts in the Cryptocurrency exchanges registered out of India. Some of these exchanges are Poloniex.com, Bittrex.com, Cryptopia.com, Kucoin.com etc. These exchanges trade in hundreds of cryptocurrencies other than Bitcoins. Here, he has earned huge profits and the closing stock of all his other cryptocurrencies in terms of Bitcoins comes to close to 3500 Bitcoins. Today the value of each Bitcoin is ranging between 8000-10,000 US Dollars. These transactions are called as Crypto to Crypto transactions.

Profit margins in other cryptocurrencies are significantly higher as compared to Bitcoin due to their low base price. Therefore, investors/ traders convert their Bitcoins in other cryptocurrency to earn higher profits. Investors/ Traders are allowed to trade in various crypto currencies through the websites based outside India. These transactions are basically in the nature of "Crypto to Crypto" transactions.

The exchanges/ websites like Bittrex.com, allow the users to trade from one crypto currency to another crypto currency. Investors earn profit on conversion of one cryptocurrency into another cryptocurrency. This cryptocurrency is again converted into another cryptocurrency. At each conversion investor/ trader makes profits. These Crypto Currencies are convertible into Bitcoins and these Bitcoins are again sold in India for the fiat currency.

Mr. ABC has earned huge profits by participating in the Initial Coin Offering (ICO) of a Cryptocurrency called IOTA. He participated by investing Rs. 2 Lakhs in the IOTA coin and he has made crores in IOTA coin due to unprecedented increase in the price of IOTA.

As stated above Mr. ABC has invested in Cryptocurrencies and has eared huge profits by converting one cryptocurrency into another cryptocurrency. To calculate the profits on accrual basis on conversion of one crypto currency in to another crypto currency following method was followed:

> *"At each conversion of one Crypto currency into another Crypto Currency, investor/ trader makes profits and hence profits have to be calculated on accrual of income. For this, reference price of Bitcoin at the time of conversion needs be taken to convert it into INR and calculate his total profits. For calculating realized profits from crypto to crypto transactions, use of websites such as cointracking. info was made. These websites imports data of all the transactions of client from various websites such as Btfinex.com, Bittrex.com etc. They also allow user to upload transaction data in excel format. After uploading of all cryptocurrency transaction data, they capture cost of the cryptocurrency at the time of transaction and arrive at realized and unrealized profits. The profits are calculated by applying FIFO method in this. It also gives profit and loss account of the user".*

By following the above-mentioned method, profits earned by Mr. ABC were calculated as on 31.12.2017, which are tabulated as below:

Sr. No.	Financial Year	Total Purchases	Total Sales	Total Expenses	Total Profits in INR	Total closing balance at cost
1.	2015–16	47,92,130	51,05,396	1,95,438	1,17,828	17,56,226
2.	2016–17	9,26,29,130	9,94,87,358	26,69,543	41,88,685	73,50,995
3	2017–18 as on 31.12.2017)	101,99,30,120	1,51,46,78,187	2,71,73,046	46,75,75,021	37,17,89,739

This profit was confirmed in statement u/s 131 of I.T. Act 1961 recorded on 24.01.2018 by Investigation Directorate, Bangalore. Immediately after the statement Mr. ABC made advance tax payment of Rs. 22.50 Lakhs for FY 2017–18. In the month of March 2018, Mr. ABC has paid advance tax of Rs. 30 Crores as he has transacted in other Crypto Currencies after the 131 statements and withdrawn the fiat currency for payment of due taxes.

CHAPTER

14

Digital Evidence and Forensics

1. BACKGROUND

One of the key objectives of our functioning as a taxman is to collect necessary evidences against the tax evaders so as to make an infallible case of tax evasion by way of passing a well reasoned assessment order. In fact all our efforts in searches and surveys are invariably directed towards collection of such evidences which could be utilised in establishing a case of tax evasion.

With the advent and further advancement of technology, more and more people have shifted to Electronic media for maintaining their regular books of accounts as well as other business transactions. The records maintained on such media are called Electronic documents or Digital documents. Computers, laptops, palmtops and mobile phones are the instruments to maintain or access those documents electronically. Needless to say that Digital Evidences are as important as other documentary evidences. However, in the course of investigation, it is extremely important to bring them to the presentable form as evidence. This chapter deals with how to gather digital evidences.

As per the Indian Evidence Act 1872, evidences are of two types namely-Oral and Documentary. Documentary evidences are further divided into Primary and Secondary evidences. Documentary evidences are all documents including electronic records produced for the inspection of the Court. Further, as per Section 2(22AA) of the Income-tax Act 1961, document includes an electronic record as defined in Section 2(1)(t) of the Information Technology Act 2000.

Primary evidence is the document itself while secondary evidence may be in the form of certified copy or Xeroxed copy etc. Normally documents are required to be proved before a Court of law only by Primary evidence, except under certain circumstances such as when the original document is destroyed.

For admissibility of the electronic record, there is a special provision contained in Section 65B of the Evidence Act 1872, which is a non-obstante Clause and states as under:

"Any information, contained in an electronic record, which is printed on a paper, stored, recorded or copied in optical or magnetic media produced by a computer, referred to as computer output, shall be deemed to be also a document, and shall be admissible in any proceedings, without further proof or production of the original, as evidence of any contents of original."

Thus the digital record or electronic record enjoys a special status. The computer output may be produced as evidence before the Court without the need of production of original source.

2. BASIC CONCEPTS

1. Digital evidence' means information of probative value stored or transmitted in digital forms. It could further be defined as information and data of value to an investigation that is stored on, received or transmitted by an electronic device. This evidence can be acquired when electronic devices are seized and secured for examination. Digital evidences could be latent (hidden) like fingerprint or DNA, altered damaged or destroyed with little efforts and it could be time sensitive. Moreover, it crosses jurisdictional borders quickly and easily.

Some examples of digital evidences are word processing documents, WhatsApp chat communications, files saved from accounting programs, spreadsheets, computer printouts, e-mails, digital photographs, ATM transaction logs, instant message histories, Internet browser histories and digital video or audio files. There are many sources of digital evidence. But for the sake of convenience, it can be divided into three major categories, which are Internet or intra net based, stand-alone computers or other such devices and mobile devices. These areas tend to have different evidence-gathering processes, tools and concerns.

2. The definition of "electronic record" is given in Section 2(1)(t) of information Technology Act 2000 as follows:

"electronic record" means data, record or data generated, image or sound stored, received or sent in an electronic form or micro film or computer generated micro fiche.

3. The Income-tax Act, 1961 recognises electronic record, as defined in the Information Technology Act, as 'document'. The Act has been amended thrice by way of Finance Act 2001, Finance Act 2002 and Finance Act 2009 thereby according recognition to electronic evidence, facilitating access to them and giving when need be, powers to impound and seize them. The key amendments in this regard are as below:

By Finance Act, 2001: Clause (22AA) was inserted in Section 2 to provide that the term "document" in Income-tax Act, 1961, includes an electronic record as defined in Section 2(1)(t) of the Information Technology Act, 2000.

By Finance Act, 2002: Clause (iib) was inserted in Sub-section (1) of Section 132 requiring any person who is found to be in possession or control of any books of account or other documents maintained in the form of electronic record as defined in Section 2(1)(t) of the Information Technology Act, 2000 (21 of 2000), to accord the authorised officer the necessary facility to inspect such books of account or other documents; and

By Finance Act, 2009: Clause (c) was inserted in sub-section (1) of Section 282 providing that service of notice in the form of any electronic record as provided in Chapter IV of the Information Technology Act, 2000 (21 of 2000) will constitute valid service.

General Information Regarding Digital Devices:

4. Computer is the principal digital device. There are, however, a number of other audio, video, communication and photographic devices, which can also be described as digital devices. Some digital devices that an authorized

officers may come across in the course of a search or survey are:

a. Desktop computers;

b. Smart phones;

c. Pen drives, external hard disks, various types of flash drives;

d. USB I-pods, USB MP3 players;

e. CD and DVD media, memory chips (such as SD cards used in smartphones);

f. Servers;

g. Cloud data servers.

5. While stand—alone desktop computers are easy to identify, it requires some inspection to find out whether they are networked. The networking may be through cabling that are visible or through satellite, microwave, terrestrial line or other communication media that can be detected through examination of the operating system (OS) that is used. For example, when Microsoft Windows is used as the OS, the menu item 'My Network places' in the control panel will reveal this information.

6. With fast changes in information and communication technologies, new challenges in securing digital evidence keep propping up. For instance, most software service providers are now moving towards a model called the 'Software as a service' model, wherein accounts are maintained in a cloud storage device. In cloud storages, the digital data is stored in logical pools, the physical storage spans multiple servers (and often locations), and the physical environment is typically owned and managed by a third-party hosting company. These cloud storage providers are responsible for keeping the data available and accessible, and the physical environment protected and running. People and organisations buy or lease storage capacity from the providers to store user, organisation, or application data. Investigating officers should remain abreast with the changes in technology and changing methods of extracting digital evidence.

7. The team conducting a search & seizure operation usually hires experts to conduct digital forensics at search and survey premises. As far as possible, the Control room should select a technical person of the Central Government for this job so that the Authorised Officer can requisition the services of such an officer in exercise of the powers conferred on him under Section 132(2) of the Act. Secondly, the level of their integrity, accountability and commitment to the government job is expected to be more than those of an expert from a private organisation. However, even where a Private expert is engaged for this purpose, the Authorised Officer or other officers at spot should keep close supervision on the functions performed by the expert. It would be preferable to even keep a written trail of the processes engaged by the expert so that the same could be reviewed if need arises.

Do's & Don'ts when Handling Digital Evidence During Search & Survey Operations

8. It is important to keep in mind that the do's and don'ts are to be followed by the search/ survey team so that digital evidence they come across during a search/ survey action is not tampered with or destroyed. Some of such actions are listed as under:

Do's

i. Take control of mobile phones, electronic diaries etc. as smartphone's apps can be used to operate remote devices to access the data therein. These devices can be operated remotely and innocuously without being noticed.

ii. Take control of the computer systems and their power supply to prevent deliberate switching off of the system.

iii. Disconnect routers, modems or any other wireless LAN devices to prevent remote access. If the search team does not know

how to do it, do not allow anyone to access these devices till expert help is available.

iv. Search for storage devices such as pen drives, CDs, DVDs etc.

v. Identify the key persons in-charge of the systems.

vi. Make an exhaustive inventory of systems and peripherals.

vii. Make a list of hard disks to be seized.

viii. Make a list of important folders/ files to be copied. Generally the entire disc will be copied and data retrieval will be done only with the help of the copy of the disc but if it is found that there are some important files in the systems, making a note of these files may be useful later. It is preferable to take a mirror image of the hard disc or the storage device rather than to copy the files by accessing and operating the device.

ix. Obtain print outs (preferably with the help of an expert), if feasible.

x. Record the seizure of material in the Panchnama meticulously.

xi. Record statements of authorized personnel about user levels, access passwords, operating systems, accounting package modifications, encryption algorithms used, etc. and other relevant issues. On technical questions, the authorized officer may take the help of an expert while recording the statement, though the statement has to be recorded by the authorized officers only.

Don'ts

i. Do not switch off any computer that is working as this will cause loss of volatile data in the memory of the computer, which may be of crucial importance. Additionally, it would involve the need to invoke passwords to re-login and initiate programs. The assessee might get an opportunity to prevent crucial programs from loading.

ii. Do not allow any personnel of the assessees to access or operate the system.

iii. Do not allow any unauthorized inputs or keystrokes even by the members of the search team.

iv. Do not allow remote operations.

v. Do not allow removal of any materials such as CDs, DVDs, or devices from the premises.

vi. Do not allow any person, even from the search team not conversant with computers to deal with them in any manner.

Pre-investigation Assessment of Data Environment

9. The first step in Digital Evidence Analysis is the Pre-Investigation Assessment of what Digital Evidences needs to be acquired, imaged etc. Typically premises can be broadly dealt under:

i. Residence with one or few computers, hand held devices;

ii. Office with few computers;

iii. Companies/ Organisations with vast and complicated network of systems;

The investigating officer should carefully survey the premises, observe and assess the situation and decide on the steps for proceeding further. The digital evidences are highly fragile and these will be available at a number of devices, locations and in various formats. Hence, it is important to do a preliminary review of the premises to identify the key digital devices available at the premises. The Authorised Officer can consult an expert in matters pertaining to pre-investigation assessment of data environment. Various steps to be taken in evaluation of premises are as under:

- Disable the LAN
- Disable CCTV

- Identify important PCs
- Identify the location of servers
- Collect passwords
- Secure mail boxes by changing passwords
- Identify volatile data, if any
- Identify server hardware architecture
- Identify customised software used
- Identify cloud data
- Identify all key mobile devices
- Identify history of USB media connections

SOP for Gathering Digital Evidence

10. Owing to the delicate nature of digital evidence and the nuances involved in preserving digital evidence, it is preferable for officers conducting search & seizure operations to follow certain standard operating procedures (SOP). A SOP for gathering digital evidence is detailed as under:

I. Secure the premises both physically and electronically. Computers, other peripherals are likely to be found on all floors on the office space. The servers, networking devices will be usually installed in a separate enclosure. The following actions are to be taken up immediately on entering the premises:

   a. The employees should be kept outside the main data centre, server room and should be directed not to switch on the systems;

   b. Check for the networking devices and also the internet access. The internet services, Wide Area Networks (WAN) and Local Area Networking (LAN) should be disconnected in all cases except in cases where most critical applications are running;

   c. Photographs/ video recording of the server room and other major facilities should be taken;

   d. The personnel should be requested to empty their pockets and the contents should be examined. Pen drives or other storage devices should be collected and taken into possession. Smartphones are also classified as computers. The smartphones used by the important persons in the value chain should be taken into custody and examined;

   e. While disconnecting the network, the wireless devices should also be turned off;

   f. The systems that are already switched off should not be switched on. The systems that are already switched on should be examined. These systems are to be switched off or disconnected from the network. In case of systems that are supporting mission critical functions, they can be left as it is.

II. Make sure that the computer is in switched off mode. Sometimes some screen savers may give a false notion that the computer is off. For this the hard drive and monitor activity lights should be checked to see whether the computer is on. In case of laptops, on opening the lid, the laptop may open. So it is advisable to remove the battery from the laptop computers.

III. In case of a computer, search for all wireless/ wired networks connected to the computer. Document all connections to the computer. In case computer system is connected to a network, ask the system/ network administrator to isolate the system from the rest of the network. Capture all the details of shared net connections, active network connections to the computer. If the system cannot be taken off the network or in switched on mode, live imaging of

relevant data can be carried out using appropriate tools.

IV. In case of live systems also recover volatile memory dump/ RAM Memory dump using appropriate tools. Also check whether there is an encryption volume in the system. Appropriate software can be used to retrieve the encryption volume.

V. In case of hard disks taken out from switched off PC's record unique identifiers like make, model and serial number.

VI. Get the signatures of the assessee and witness on the hard disk using a permanent marker.

VII. Search for Non-electronic evidences like diaries, notebooks or pieces of papers with passwords.

VIII. After the Hard disk is removed, Switch on the system and go to BIOS. Note down the date and time shown in BIOS.

IX. Connect the Hard Disk for logical back up or forensic imaging/ cloning.

X. In case of switched on computers, if live imaging is not possible, remove the power supply from the back of the computer without closing down any programs. When removing the power supply cable, always remove the end attached to the computer and not that attached to the socket, this will avoid any data being written to the hard drive if an uninterruptible power protection device is fitted.

Access to the Data Storage Devices, Password Protections

11. Section 132(1) of the Act empowers the Authorized Officer to require any person found to be in possession or control of any books of account or other documents maintained in the form of electronic record to afford him (Authorized Officer) the necessary facility to inspect such books of account or other documents. In view of this statutory provision, the person concerned is legally duty-bound to tell the password and other information required for accessing such data. In case, he refuses to do so, the fact should be recorded in the form of a statement on oath, in presence of the witnesses. Failure on the part of a person to comply with the provisions of Section 132(1)(iib) of the Act renders him liable for prosecution under Section275B of the Act.

12. There may be situations where access to a device is protected by passwords. There could be passwords to access the system or individual files may be password protected or encrypted. There may be different levels of securities. Primarily it is the work of an expert to break through these passwords. The Authorised Officer should be aware that through it is a painstaking and arduous process, in many cases, such passwords can be cracked by experts. If one comes across files, the contents of which do not make sense, it could be an encrypted file and expert help should be taken to understand or decrypt it. Such files or for that matter any other files should not be deleted considering them irrelevant or inconsequential.

13. To login to a LAN environment, the Authorized Officer should know the password of the super user or supervisor. This may be obtained from the person found to be in-charge of the system. It is only after logging in to the LAN environment that the authorized officer can have access to its contents and possible manipulation of data.

Retrieval of Deleted Files

14. Restoring the deleted files from the Windows Recycle Bin is a simple task. However, while restoring the files from the Windows Recycle Bin, due care should be taken that a file having same name in the destination folder is not overwritten. But even if the files are deleted from the Recycle Bin itself 'permanently', still it is possible to retrieve the files in certain circumstances through bit-by-bit mapping of the hard disks of the

computer as described below. Utilities/ Software are available in market, which could be used to restore and read such files.

15. Every operating system uses what is known as a file allocation table (FAT) to maintain information about sector-wise storing of files. Every file that is stored in a computer is split into parts and stored in clusters/ sectors. It is not necessary for the operating system to store files contiguously. A file may be stored in hundreds of different locations in a hard disk. Whenever necessary the operating system will recover it and present it to the user as one whole. When a file is deleted the FAT simply changes the name of the file and removes it from its table. However, all the data that were in the file continue to remain in the hard disk unless overwritten. Because of this feature, even permanently deleted files can be recovered using commercially available software. It is, therefore, advisable to examine the contents of the hard disk drive (copy) for such deleted files, which may contain information about unaccounted transactions.

TYPES OF DIGITAL DATA AND MODES OF RETRIEVAL

Books of Account

16. An accounting software is used to maintain books of accounts in electronic form. The simplest and most prevalent accounting software is Tally. Other than Tally, Enterprise Resource Planning (ERP) software can be used. SAP is an advance accounting software used to maintain books of account.

17. Accounts maintained in Tally are usually extracted by doing a forensic cloning. Forensic cloning generates a bit by bit copy of the original media, including free space and slack space. Tally data can be accessed by doing a mere logical back up; however, a logical back-up does not capture deleted data. Parallel accounts maintained in Tally are often deleted in end-of-month and such data can be retrieved only by conducting a forensic cloning. Popular software for doing forensic cloning are FTK Imager and Encase. Analysis of Tally data can be done by using the following data mining techniques:

Data Mining and Analysis in Tally	
Balance Sheet display	Go to Gateway of Tally > Balance Sheet and Press Alt+F1 for detailed view. This will give the Balance Sheet in horizontal form. To view the Balance Sheet in vertical form, use following steps: • Gateway to Tally> Balance Sheet • Press Alt + F1 for detailed view • Press F12: Configure and set Show Vertical Balance Sheet to Yes • Press Enter to accept the screen and to view vertical Balance Sheet If you want you see the Balance Sheet with percentages and working capital then use following steps: • Gateway to Tally> Balance Sheet • Press Alt + F1 for detailed view • Press F12: Configure and set yes: (a) Show Percentages and (b) Show Working Capital Figures • Press Enter to accept the screen and to view vertical Balance Sheet 2.

Data Mining and Analysis in Tally	
Comparison of quarterly and half-yearly data	• Gateway of Tally> Balance Sheet • Press Alt+F1 • Press F2 and specify the dates • Press Alt+N and select Quarterly from the drop list in Repeat using field. Using the same drop list you can also compare on 4 Week Month, Daily, Fortnightly, Quarterly basis.
Verification of fixed assets	• Go to Gateway of Tally > Balance Sheet • Press Fixed Assets group and Press Alt+F1 • Press F12: Configure and set YES to Show Opening Balances, Show Transactions and Show closing balances • You can also compare across years by Pressing Alt+N
Stock verification	• Gate way of Tally> Stock Summary • Press Alt+F1 for detailed view • Press Alt+F2 and specify the period • Press F12 and configure the items you want to look at • To know product wise profitability of each stock item, Press F7: Show Profit To choose multiple valuation methods, Press Alt +N and select Stock Valuation methods from drop down list. You can also compare across different Stock Valuation Methods and see whether the assessee is declaring the correct stock valuation to the department. This tool is very handy in industries like Jewellery, Retail where different assessee uses different stock valuation methods.
Verifying receivables/ payables balance	• Go to Balance Sheet and Enter Sundry Debtors and Sundry Creditors • Press Alt+F1 for detailed view Initial analysis like ageing of outstanding bills and analysis of balances over a period of time provides hints about doubtful accounts on which the officer in charge may go for detailed examination of genuineness of the transaction. The ageing analysis for Sundry Creditors is done in the following way: • Gateway of Tally> Balance Sheet • Enter Sundry Creditors Group • Press Alt+F1 for detailed view Press F8 and select Bill wise details from the list of reports • Press F6: Age wise and select Ageing by due date and enter. • If you want to alter the ageing dates, a screens appear where you can alter the ageing details. Press Enter to accept the screen. The same method can be used for viewing Sundry Debtors Account
P&L Statement year-wise analysis	• Press F1 and load previous year's data • Highlight current year data • Gateway of Tally> Profit and Loss A/c • Press Alt+F1 for detailed view • Press Alt+C to insert column. In this specify the relevant details and press enter. Officer in charge can inspect any abnormal changes in expenses over a period and specifically verify those bills to detect evidences for inflation of expenses

Data Mining and Analysis in Tally	
Ratio Analysis	To view Ratio Analysis report, use following steps: • Gateway to Tally> Ratio Analysis • Highlight the relevant ratio (Current ratio, Quick ratio, Debt Equity ratio, Gross Profit%, Net Profit%, Recv. Turnover in days, Inventory Turnover, etc) and press Alt + F1 for detailed view Officer in charge can inspect any abnormal changes in ratio over a period and specifically verify the reasons for the same. Usually Gross Profit is more or less constant in the industries with minor variations. However there may be substantial changes in the net profit due to different strategies used at the marketing, HR and administration levels. Any major variations in Gross Profit may be looked into after comparing with the Industry standard. Abnormally low Gross Profit Margin may indicate possibility of bogus purchases booked by the assessee
Cash book analysis	• Enter on any month • Alt+F2 and the change the period to full year • Press F12: Configure and Set Show Narrations as YES • Press Alt+F12: This gives the filter to get necessary vouchers based on certain conditions. Officer in charge may inspect the cash bill voucher for specific parties which may show splitting of bills for less than Rs. 20,000/- to avoid provisions of Section 40A(3). Officer may also look into monthly cash inflow and cashout flow statements to look into whether any abnormal changes are noticed over a period of time
Audit analysis	Gateway of Tally> Audit and Compliance > Audit and Analysis Press Ctrl+F3 and you will get details of the following Verification of chart of accounts: (a) Accounts squared off during the year (b) Not available in the current year (c) Not used (d) Not used in current year (e) Only Balances last year and used in current year (f) Only Balances, No transactions o Regrouped (g) Revenue ledgers having opening balances (h) Used only in current year Officer in charge may go deeper into these accounts since mostly these ledgers may indicate possibility of manipulations done by the assessee to declare lesser profits.
Verifying periodic payments and receipts	Gateway of Tally> Audit and Compliance > Audit and Analysis Select Periodic Payments and Receipts and Press Enter It is to be noted that payments like Salary, Rent, Pre-Paid Taxes etc are periodic payments and abnormal changes in the same are not possible. Officer in charge should look for such abnormal changes
Verifying repeated transactions	Gateway of Tally> Audit and Compliance > Audit and Analysis Select Repeated Transactions and press Enter Drill down where there are more repetitions. This indicates splitting of bills and may attract provisions of Section 40A(3)
Verifying unusual transactions	Gateway of Tally> Audit and Compliance > Audit and Analysis Select Relative Size Factor and Press Enter Huge Variation ledgers can be looked into specifically for any manipulations

18. When accounts are maintained in SAP, the data could be retrieved by taking a forensic cloning or by extracting the data into excel. The problem with conducting a cloning back-up is that the data can be used later in Income-tax office only by creating a 'SAP environment' which is difficult and cumbersome. If the Wing's forensic lab does not have a 'SAP environment', then the investigating officers cannot access the backed up data and the data becomes useless. That is why it is preferred to extract SAP data into excel sheets and then take logical back up of the excel sheet.

19. Data mining in SAP can be done by using the tool *SAP NetWeaver BW*. Data mining provides you with insights and correlations that had formerly gone unrecognised or been ignored because it had not been considered possible to analyze them. Since each company has different data mining requirements, SAP does not deliver fixed models for producing prediction results. However, the tool SAP NetWeaver BW allows you to create models according to your requirements and then use these models to draw information from your SAP NetWeaver BW data to assist your data analysis. In this aspect, SAP has more features than Tally.

20. Alternately, relevant data in SAP can be exported into an 'excel dump' and data analysis can be done easily in Excel by using in-built applications. This is an easier way of taking back-up of SAP data as well as of analysing books maintained in SAP. Usually, the forensic labs in income-tax offices do not maintain a 'SAP environment' and SAP back-up cannot be run without a SAP environment in the forensic lab. In post-search proceedings, it becomes cumbersome to extract data from a SAP forensic back-up. Hence, it is preferable to export the SAP data onto excel sheets. Such data can then be analysed using familiar tools of excel in the search premise itself as well as during post-search investigation.

21. Most mid-to-large size businesses in India tend to employ some ERP system other than Tally for various reasons. Such ERP system almost invariably is a RDBMS (relational database management system) with a front end in the form of Windows/ Java/ Web based application. Popular RDBMS databases are MS SQL Server, Oracle, MySQL etc. Some other types of databases like PostgreSQL, IBM DB2, Sybase etc might also be used.

22. When it comes to corporate ERP systems, two distinct trends have been observed:

a. **Custom Made ERP Systems:** Many companies intentionally or unintentionally develop their own in-house ERP software by employing programmers. This is one of the best case scenarios for investigation as it readily provides intricate accounting details on how transactions take place.

b. **Readymade ERP Systems:** Systems such as SAP, Microsoft Dynamics, Oracle Financials, RAMCO are examples of ERP stacks which can be bought and implemented. Although each of these systems need to be significantly customized to fit specific business needs of the firm.

23. The structure of a typical high level ERP has three tiers:

a. Client tier

b. Business logic tier

c. Database tier

24. It is very much possible that all 3 tiers are hosted on separate servers. From data perspective, Database Tier is most important. Hence backup of the database is must. Usually if RDBMS table structure is known, standard issue reports such as Purchase order details by year, trial balance by year, cash transactions by year etc can be extracted from the database itself. But if the goal is to recreate the complete ERP application off-site then imaging all the machines

involved from Database and Business logic tier and one of the client machines is must. This is the bare minimum strategy required to recreate the entire system offline.

E-mail

25. One of the first things to do after making an entry into a search premises and after completing preliminary procedures is to secure the e-mail IDs. Acquire the user id and password of e-mail account of assessee and some important persons of the business concern and change the password immediately to secure the mail box. The changed passwords should be noted down at a secured place for further analysis of e-mails.

26. For taking back up of gmail and yahoo accounts, two methods are followed. One is to request Gmail/ Yahoo for creating an archive. Then the archive is downloaded and logical back up made. Alternately, the e-mail account is configured into MS outlook and offline file is taken as back up. In many cases, we find e-mail of an assessee synched into Outlook or Thunderbird already. Outlook files are extracted as.osd files while Thunderbird files are extracted as.eml files. Thereafter, logical back up is taken.

Documents

27. Data stored in digital media are usually stored in the form of MS word files, Pdf documents, and MS Excel files. From the perspective of income-tax investigation, excel sheets are the most important. Usually shadow accounts are maintained in excel sheets. The assessee may follow a double entry accounting system or a single entry accounting system for the purpose. Books of accounts maintained in SAP are also usually exported into excel sheets for the purpose of analysis.

28. Excel has its own data analysis tool called ToolPak. The Analysis ToolPak is an Excel add-in program that provides data analysis tools for financial, statistical and engineering data analysis. In order to use it in MS Excel, one has to follow the following steps:

- In the Manage box, select Excel Add-ins and then click Go
- If you're using Excel for Mac, in the file menu go to Tools > Excel Add-ins. In the Add-Ins box, check the Analysis ToolPak check box, and then click OK
- If Analysis ToolPak is not listed in the Add-Ins available box, click Browse to locate it

Remote Storage of Data

29. It is possible to store data in a remote device with the help of internet. Detection of whether the assessee has been storing data and files in remote storage media/ websites will require some detailed probing. The history folder of the web browsers like the Internet Explorer would contain the list of sites visited. Examination of the details available in this folder may help identify remote storage of files. Similarly, e-mail account should also be scrutinized. The active files, backup files, log files, configuration files, printers, cookies, swap files, hidden files and system files should also be examined to find out the possibility of remote storage as well as locally concealed storage. Within the device or hardware, it can reside in various types of files and folders and in software like accounting package and enterprise resource packages. Apart from the local storage devices, there are options to store data in websites, which offer the facility for a fee or are free. These days, storage in Google docs is also prevalent. Free e-mail facility of large storage capacity is also offered by many service providers. When important data are stored in such devices, the passwords and other relevant information are written in some diary, note book etc and a vigilant person can identify that these are passwords.

Mobile Phone Data

30. Mobile device forensics is a branch of digital forensics relating to recovery of digital evidence or data from a mobile device under forensically sound conditions. The phrase mobile device

usually refers to mobile phones; however, it can also relate to any digital device that has both internal memory and communication ability, including PDA devices, GPS devices and tablet computers. Mobile devices can be used to save several types of personal information such as contacts, photos, calendars and notes, SMS and MMS messages. Smartphones may additionally contain video, e-mail, web browsing information, location information, and social networking messages and contacts.

31. Depending on situation, the officer-in-charge may decide to seize the mobile or take a backup or take an image of the mobile device. Procedure for gathering evidence from Mobile Phones is as under:

a. If the device is—OFF‖, do not turn—ON‖

b. If the device is—ON‖, do not turn—OFF‖. Powering down device could enable password, thus preventing access to the evidence

c. Photograph device and screen display

d. Label and collect all cables (including power supply)

e. Note that you should do the imaging prior to it gets discharged. Keep the device charged

f. Seize additional storage media like memory sticks etc.

g. Document all steps involved in seizure of device and components

h. A Faraday bag may be used by the officer in charge to avoid in signals. This prevents any changes that may take place in the phone by receiving a signal. So evidence cannot be manipulated till acquisition.

32. If the mobile device runs on iOS, then cloning is conducted using PhoneRescue software and Oxygen Forensics. In an iphone device, one can also give a request to Apple to make an itunes back up. This back up can be downloaded directly and a logical back up can be taken. If the mobile device runs on android OS, software such as ufed and Oxygen Forensics are used to conduct cloning.

Chat Data

33. Chat Applications such as WhatsApp, WeChat, and Hike are popular apps used for communicating important business decisions. It is important to look out for these apps and take back up of chat data shared via these applications. Standard cloning methods apply for taking back up of chat data too. However, a better way of taking back up of WhatsApp conversations is to temporarily configure the WhatsApp in a computer by using the verification code that is sent to the assessee's mobile phone. Thereafter the entire data can be extracted from the computer itself in pdf or image format and then an unique hash value can be created.

FORENSIC DUPLICATION: CLONING AND LOGICAL BACK-UP

34. Forensic Duplication is a process of bit-stream imaging of the digital evidence by which entire data is transferred to a storage medium. Files can be copied from suspected storage media using two different techniques: logical back-up and forensic cloning. A Logical back-up copies the directories and files of a logical volume. It does not capture other data such as deleted files or residual data stored in slack space. A forensic cloning generates a bit by bit copy of the original media, including free space and slack space. Disk Imaging usually takes more space and takes longer time to perform.

35. The table below gives a comparison between the two methods of forensic duplication:

Doing a logical back-up	Doing a forensic cloning
Backup is copying the selected files and folders logically.	Forensic Imaging is copying the physical sectors of the hard disk irrespective of files, folders or empty.
It changes the metadata of the files.	No change of metadata since it uses write blockers.
Assessee can allege that Departmental officers manipulated data because MAC (Media Access Control) timings change during back-up process.	MAC (Media Access Control) timings do not change and the tools are write protected.
Executable programs are not accounted.	Such programs could be examined.
Recovery of deleted files is not possible.	Deleted files could be recovered.
No hash values are generated for the system.	Hash value is generated for the whole disk and so also for single files.
Post search no detailed analysis such as registry info, timelines, and connected devices could be carried out.	Post search, all such analysis could be done.
Backup copies only visible &known files/ folders.	Imaging copies whole system of the assessee.
Backup doesn't give internet history/ chats/ information regarding internet usage.	Imaging gives internet history, chats and also carve out deleted skype messages/ chats.

36. Whether to image or backup a particular device is discretion of the Authorized officer. Imaging is a much longer, time consuming process which typically requires considerable storage. Backup is relatively quicker, to-the-point procedure and storage requirements are considerably less. However if the digital device has critical data which can be challenged in the court of law, it is always advisable to image the system. One more drawback of the data back-up is that deleted files cannot be retrieved from these Data Back Up. If the officer in charge is sure that there are substantial deleted files in the system, he should image the system instead of taking data back-up. However data back-up is very handy in places where it is difficult to get forensic teams especially in mofussil areas. Even in SAP/ ERP/ Accounting Servers it is advisable to clone the devices.

Forensic Imaging/ Cloning

37. If on previewing, important data is found either in deleted or in active form, the storage medium is required to be cloned for evidence purpose. Otherwise a normal data backup can be taken. The following steps should be taken at the time of cloning:

- Preparation: As part of preparatory work, it is necessary to start with preparation of blank disks for use in cloning. These disks will need to be forensically wiped to ensure that no data is present. This eliminates any possibility of contamination of data of source disk by any old data present on the hard disk on which cloning is to be done. This will require digital wiping hardware which can wipe disks at high speed.
- After wiping the destination hard disk i.e. the hard disk on which we will clone or copy, the same is connected to the laptop or any computer system where the data acquisition software is loaded through write blockers. This will ensure that no changes take place in the data being acquired at the time of viewing, analysing or cloning. Some hardware's come with built-in write blockers. Therefore, separate use of write blocker is not required. It should be kept in mind that maintaining data integrity while imaging is essential for establishing the acquired data as admissible evidence in a court of law/ or any subsequent proceeding.
- In case of places where high end forensic equipment are not available, a simple setup such as a high-end laptop equipped with Write blockers and forensic software kit would ensure Write-Protected previewing and acquisition of data from all types of system interfaces at the site itself.
- In cases where very high capacity disks/ servers (Over 200 GB) are found at the

search premises, separate Hardware imaging devices, which are up to ten times faster, would be needed. These hardware devices have in-built authentication engines. On completion of the imaging process, the device displays the hash value of the cloned hard disk. The image/ clone has to have the same hash value as that of the target hard disk. The Hash value should be recorded in the Panchnama and the assessee can be given the option of seeking a copy of the imaged/ cloned hard disk by paying the copying charges.

Network Forensics

38. Network forensics is a sub-branch of digital forensics relating to the monitoring and analysis of computer network traffic for the purposes of information gathering, legal evidence, or intrusion detection. Unlike other areas of digital forensics, network investigations deal with volatile and dynamic information. Network traffic is transmitted and then lost, so network forensics is often a pro-active investigation. Network forensics generally has two uses: (A) Monitoring a network for anomalous traffic and identifying intrusions (an assessee might be able to erase all log files in a server before the search team could secure the premise; network-based evidence might therefore be the only evidence available for forensic analysis) and (B) Analysis of captured network traffic can include tasks such as reassembling transferred files, searching for keywords and parsing human communication such as e-mails or chat sessions.

39. Two systems are commonly used to collect network data. They are as under:

I. "Catch-it-as-you-can"—This is where all packets passing through a certain traffic point are captured and written to storage with analysis being done subsequently in batch mode. This approach requires large amounts of storage.

II. "Stop, look and listen"—This is where each packet is analyzed in a rudimentary way in memory and only certain information saved for future analysis. This approach requires a faster processor to keep up with incoming traffic.

40. Network forensics conducted in various layers of the network are detailed in the table under:

Network Forensics	
Ethernet	Applying forensic methods on the Ethernet layer is done by eavesdropping bit streams with tools called monitoring tools or sniffers. The most common tools on this layer are Wireshark (formerly known as Ethereal) and tcpdump (tcpdump works mostly on unix-like operating systems). These tools collect all data on this layer and allows the user to filter for different events. With these tools, website pages, e-mail attachments, and other network traffic can be reconstructed only if they are transmitted or received unencrypted. An advantage of collecting this data is that it is directly connected to a host. If, for example the IP address or the MAC address of a host at a certain time is known, all data sent to or from this IP or MAC address can be filtered. To establish the connection between IP and MAC address, it is useful to take a closer look at auxiliary network protocols. The Address Resolution Protocol (ARP) tables list the MAC addresses with the corresponding IP addresses. To collect data on this layer, the network interface card (NIC) of a host can be put into "promiscuous mode". In so doing, all traffic will be passed to the CPU, not only the traffic meant for the host.
TCP/ IP	On the network layer the Internet Protocol (IP) is responsible for directing the packets generated by TCP through the network (e.g., the Internet) by adding source and destination information which can be interpreted by routers all over the network. Cellular digital packet networks, like GPRS, use similar protocols like IP, so the methods described for IP work with them as well.
Internet	The internet can be a rich source of digital evidence including web browsing, e-mail, newsgroup, synchronous chat and peer-to-peer traffic. For example, web server logs can be used to show when (or if) a suspect accessed information related to criminal activity. E-mail accounts can often contain useful evidence; but e-mail headers are easily faked and, so, network forensics may be used to prove the exact origin of incriminating material. Network forensics can also be used in order to find out who is using a particular computer by extracting user account information from the network traffic.

41. Network forensics is an important aspect of investigation during search & seizure operation. The Authorised Officer and specialists should conduct network forensics in order to understand the online behaviour of target assessee: which all sites he/ she visited, which e-mail accounts (including pseudonymous accounts), online databases, and online servers he regularly accesses etc. Network forensics also helps the investigating team find out if an assessee does foreign currency trading online (which is illegal under FEMA), or cryptocurrency trading in foreign exchanges (which is used to facilitate hawala). Network forensics also throws light on the bank accounts (including undisclosed foreign bank accounts) that an assessee operates online.

Important Documentation for Retaining the Integrity of Data Retrieved

42. The collection and maintenance of electronic record has to be carefully done for its admissibility by the Courts of law as such evidence is considered secondary evidence under the Indian Evidence Act, 1872. In many cases, the digital evidence has not been admitted due to improper copying process which may not be the exact copy of the physical evidence. *In the case of Anwar PV vs. PK Basheer & Ors, the court has overruled its previous ruling on admissibility of electronic evidence (secondary evidence) in state vs. Navjot Sandhu (2005) 11 SCC 600.* The denial has been on the ground that steps have not been taken to maintain integrity of data resulting in change of time stamps and also possible tampering of evidence.

43. The Authorised Officer and his team should seize the devices containing the digital evidence in such a manner that the integrity of data on the original cannot be questioned. Internationally, hash functions or message digest functions are used to prove the integrity of digital data. According to Section 3 of the Information Technology Act, 2000, the authentication of the electronic record shall be effected by the use of asymmetric crypto system and hash function, which envelop and transform the initial electronic record into another electronic record.

44. For the purpose of maintaining integrity of data retrieved, so that they can stand as evidence in a court of law, four important documentation needs to be properly recorded and maintained by the Authorised Officer and his team in the search premise. These are as under:

1. Digital Evidence collection form
2. Chain of custody form
3. Mobile devices collection form—checklist
4. Certificate *u/s* 65B of the Indian Evidence Act, 1872

45. Digital Evidence Collection Form ensures proper documentation of all the information about the evidence that is visible to the naked eye. It should contain the following details:

- Case Name/ Date of Search/ Name of the Authorised Office and Address of acquisition
- System Information like Device Type/ Manufacturer/ Model Number/ Serial Number/ BIOS Date(Time)
- Type of Media
- Details of Forensic Software and Version Number

46. Chain of Custody refers to the documentation that shows the people who have been entrusted with the evidence. It should document the details of the people who seized the equipment, the details of people who transferred it from the premise to forensic labs, people who are analyzing the evidence, the details on when it was opened and so on. This is very important since the assessee may level charges of tampering and fabrication of evidence and it would be difficult to prove the integrity of the evidence, if the chain of custody is not maintained. It is advisable to maintain a Chain of Custody form along with Digital

Evidence Collection Form. Filling up a mobile device collection form is not mandatory from a legal point of view, but it is advisable for the Authorised Officer to fill it up, as the form is a checklist and hence an appropriate record of the mobile devices found and forensics conducted.

47. A certificate under Section 65B of the Indian Evidence Act, 1872 is a legal requirement in order for the evidence so collected to become admissible in a court of law. *In the case of Anwar PV vs. PK Basheer & Ors*, the court has stated that compliance of Section 65B is mandatory for persons who intend to rely upon electronic record in civil or criminal trials. The court further goes on to hold that provision such as Section 45A of Information Technology Act which provide for opinion of examiner of electronic evidence can only be availed once the provisions of Section 65B are satisfied. Hence, a certificate under Section 65B of the Indian Evidence Act, 1872 is a must for protecting the integrity of digital evidence.

48. Copy of the four forms discussed above are attached at the end of the chapter.

Popular Software used in Digital Forensics

49. The software used in digital forensic can be (functionally) for acquiring data from the electronic instrument, *or* for analysis of data. The most popular software used for acquiring data is FTK from AccessData. FTK stands for 'Forensic Tool Kit'. FTK is used for creating cloned image of the data being extracted. FTK has in-built facilities for generating hash value.

50. Popular software used for analysis of data are UFED from Celebrite, Oxygen Forensics, Xways forensics, and MailXaminer. UFED and Oxygen Forensics are popular software for analysis of data extracted from mobile phones. Oxygen Forensics is compatible to laptop and desktop operating systems also. MailXaminer is used for searching keywords in mail boxes. MailXaminer also helps in recovery of deleted e-mails, processing of mailboxes in suitable formats that are accepted in courts, and conduct of data analytics on seized e-mail data.

51. Autopsy by Sleuth Kit is a tool used in income-tax offices and forensics labs after the digital evidence has been retrieved and seized by the AO. Autopsy is useful to conducting DDIT for making analysis in post-search proceedings. This tool helps in timeline analysis, hash filtering, keyword search, web artefact extraction, and data carving (recovery of deleted files).

Empanelment of Experts

52. Search teams, not being experts, cannot be expected to be hands-on with forensic software, although it is desirable for the Authorised Officer to be fluent in using forensics software. Owing to this limitation, investigation wings may have to empanel experts for assisting them in digital forensics. Empanelment of experts has to follow the standard directions in General Financial Rules (GFR). Usually, a tender is floated and two rounds of scrutiny is conducted: technical round and commercial round. In the technical round, the background of the vendor, the qualification of its experts, the work profile handled by the vendor etc are checked. Then in the commercial round, the vendor offering the most competitive rates is selected.

Digital Evidence Collection Form			
Name of the Authorized Officer:			
Name of the assessee:			
Date:	Time:	Premise Address:	
Examiner's Name and Details:			
Computer Information			
O Laptop	O Desktop	O Server	OFile/ Folder
Others	If Others Specify		
System State O On Off Hibernation/ Sleep		If switched On, What is visible on screen?	
System Info	Make: _____Model:_____ Serial No:_____Size:_____		
Whether Volatile Memory/ RAM Memory was collected?_____			
Shut Down Type	Normal Power Plug Pulled Battery Removed(Laptop)		
Is the suspected media encrypted? **Yes No**		**Type of encryption Software used**	
Hard Disk Handling: Seizure Forensic Previewing Imaging Backup			
Details of Imaging Software/ Version to be given			
Is the hash value calculated? **Yes No**		**Algorithm:** **MD5 SHA OTHERS**	
MD5 hash value:			
SHA hash value:			
Other Authentication Method:			
Storage Copy Details Make:_____Model:_____ Serial No:_____	Working Copy Details Make:_____Model:_____ Serial No:_____		
Is the hard disk replaced back? Yes No	Date:	Time:	
Is the signature of the witness taken? Yes No			
Note by the AO regarding the potential evidences in the digital devices:			

Chain of Custody Form					
Name of the assessee:					
Date	Time	Premise Address			
Description:					
Chain of Custody					
Reason/ Action	Received form	Received by	Date	Time	Signature of Parties

Mobile Devices Collection Form-Checklist

Name of the Authorized Officer:

Name of the assessee:

Date	Time	Premise Address

System State	If switched On, What is visible on screen?
O On Off Hibernation/ Sleep	

System Info	Make: _____ Model: _____ Mobile Type: O GSM O CDMA O 3G O Others If Others Specify _____ Time Zone Settings: _____ Date/ Time of Mobile Phone: _____ Actual Date/ Time: _____

IMEI/ MEID Number
Mobile Serial Number (If any)
Operating System
(Including Version Number)

Is the SIM Card Present? O Yes O No	SIM Service Provider Name:
SIM Card Size O O	IMSI Card Number
Mobile Phone State: ON OFF OFFLINE	Shutdown Type NORMAL BATTERY PULLED O O
Mobile Phone State: YES NO	Media Card Serial Number: Media Card Make and Capacity:

Does the phone has the ability to access Internet? YES No

Storage Copy Details Make: _____ Model: _____	Working Copy Details Make: _____ Model: _____

Serial No: _____ Serial No: _____

Is the Media Card Removed? Yes No	Date:	Time:
Is the SIM Card Removed? Yes No	Date:	Time:
SIM Card Replaced after Imaging? No	Date:	Time:
Is the signature of witness taken? Yes No	Date:	Time:

Note by the AO regarding the potential evidences in the digital devices:

CERTIFICATE
(Under Section 65B of the Indian Evidence Act, 1872)

I, _____(name) working as _____ (designation) in income-tax Department certify as follows:

PART-A

(1) The electronic output is a Hard Drive/ CD/ DVD (Article No. _____) of capacity _____ MB/ GB, concerning search in the premises of _____, in the case of _____ conducted by the Directorate of Investigation _____, on _____ *u/s* 132 of the IT Act, 1961

(2) It has been produced by making a forensic back up of digital evidences _____ (details of mobile, computer, pen drive etc found) found in the course of search action by _____ (name of forensic specialist) using appropriate forensic tools as documented

(3) The contents of digital evidence was produced before me by the search team on _____ and thereafter the entire contents of the said digital evidence were transferred to CD/ DVD/ Hard Disk before me in the presence of pancha witnesses by Sri _____ (name of forensic specialist) with the help of computer/ laptop on _____.

PART-B

(1) The electronic record was created from a computer/ laptop of make _____

(2) Being _____ (designation) in the Income-tax Department, I am having lawful control over the use of the computer/ laptop.

(3) The computer/ laptop has been used regularly for the designated activities.

(4) The information contained in the electronic record is reproduced or is derived from such information fed into the computer/ laptop in the ordinary course of the said activities

(5) Throughout the copying procedure, the computer/ laptop was operating properly.

This has been stated to the best of my knowledge and belief.

Dated:

Place: Signature with seal

CHAPTER

15

Forensic Investigation of E-mail Dumps

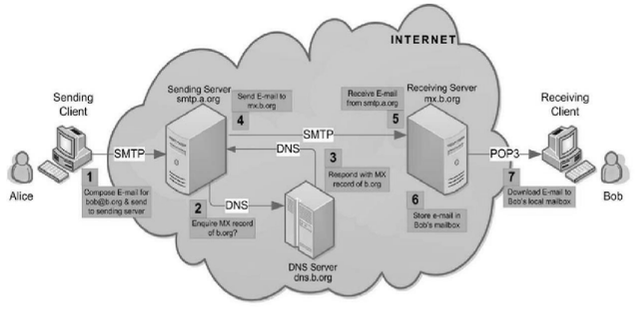
1. INTRODUCTION

E-mail has emerged as the most important application on Internet for communication of messages and delivery of documents. Most countries Recognise e-mail as legitimate documentary evidence. E-mails have been used as substantial sources of evidence in variety of cases of investigations. E-mail forensic analysis is used to study the source and content of e-mail message as evidence, identifying the actual sender, recipient and date and time it was sent, etc. to collect credible evidence to bring offenders to justice.

2. BASIC CONCEPT

A typical communication between a sender and receiver is described below:

"Alice" composes an e-mail message on her computer called client for '*Bob'* and sends it to her sending server "smtp.a.org" using *SMTP* protocol. Sending server performs a lookup for the mail exchange record of receiving server "*b.org*" through Domain Name System *(DNS)* protocol on *DNS* server "*dns.b.org*". The *DNS* server responds with the highest priority mail exchange server '*mx.b.org'* for the domain "b.org". Sending server establishes *SMTP* connection with the receiving server and delivers the e-mail message to the mailbox of '*Bob'* on the receiving server. '*Bob'* downloads the message from his mailbox on receiving server to local mailbox on his client computer using *POP3* or *IMAP* protocols. Optionally, '*Bob'* can also read the message stored in his server mailbox without downloading it to the local mailbox by using a Webmail program.



3. COMPONENTS OF E-MAILS

The major components of an e-mail are *The Users, The Message Handling Service (MHS)* and *The Administrative Management Domain (ADMD).*

3.1 The Users

There are majorly 4 types of users in an e-mail communication:

User Type	Roles and Responsibilities
Author	Responsible for creating the message, its contents, and its list of Recipient addresses.
	The MHS transfers the message from the Author and delivers it to the Recipients.
	The MHS has an Originator role that correlates with the Author role.
Recipient	The Recipient is a consumer of the delivered message
	The MHS has a Receiver role that correlates with the Recipient role.
	A Recipient can close the user-communication loop by creating and submitting a new message that replies to the Author e.g. an automated form of reply is the Message Disposition Notification (MDN)
Return	It is a special form of Recipient that provides notifications
Handler	generated by the MHS as it transfers or delivers the message.
	It is also called Bounce Handler.
Mediator	It receives, aggregates, reformulates, and redistributes messages among Authors and Recipients.
	It forwards a message through a re-posting process.
	It shares some functionality with basic MTA relaying, but has greater flexibility in both addressing and content than is available to MTAs. It preserves the integrity and tone of the original message, including the essential aspects of its origination information. It might also add commentary.
	It does not create new message that forwards an existing message, Reply or annotation.

3.2 The Message Handling Service (MHS): is responsible for end-to-end transfer of messages. It can generate, modify or look at only transfer data in the message. *MHS* Actors can be of following four types:

MHS Actor Type	Roles and Responsibilities
Originator	It ensures that a message is valid for posting and then submits it to a Relay.
	It is responsible for the functions of the Mail Submission Agent
	It also performs any post-submission that pertain to sending error and delivery notice.
	The Author creates the message, but the Originator handles any transmission issues with it
Relay	It performs MHS-level transfer-service routing and store-and-forward function by transmitting or retransmitting the message to its Recipients.
	It adds trace information but does not modify the envelope information or the semantics of message content.
	It can modify message content representation, such as changing the form of transfer encoding from binary to text, but only (as required) to meet the capabilities of the next hop in the MHS.
	When a Relay stops attempting to transfer a message, it becomes an Author because it sends an error message to the Return Address
Gateway	It connects heterogeneous mail services despite differences in their syntax and semantics.
	It can send a useful message to a Recipient on the other side, without requiring changes to any components in the Author's or Recipient's mail services.
Receiver	It performs final delivery or sends the message to an alternate address.
	It can also perform filtering and other policy enforcement immediately before or after delivery

3.3 Administrative Management Domain (ADMD): Is associated with different organizations which have their own administrative authority, operating policies and trust-based decision making. *ADMD* Actors can be of following three types

ADMD Actor Type	Roles and Responsibilities
Edge	Independent transfer services in networks at the edge of the open Internet Mail service
Consumer	Might be a type of Edge service, as is common for web-based e-mail access
Transit	E-mail Service Providers (ESPs) that offer value-added capabilities for Edge ADMDs, such as aggregation and filtering.

4. ANALYSING E-MAILS

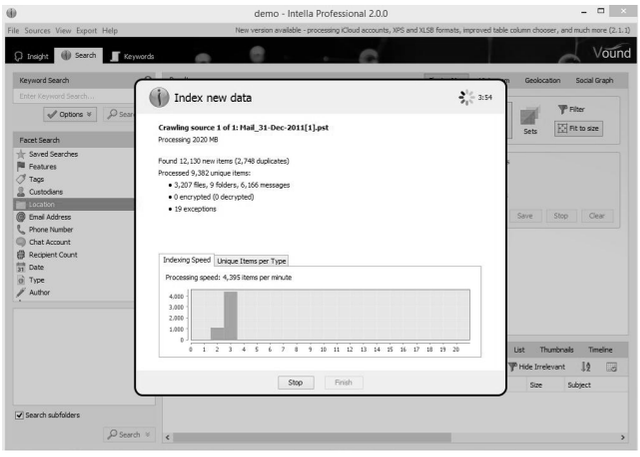
E-mail can be pivotal evidence in a case. Due to its informal nature, it does not always represent corporate policy. E-mail evidence is typically used to corroborate or refute other testimony or evidence. A forensic investigation of e-mail can examine both e-mail header and body. An e-mail investigation should consider the following:

- Examining sender's e-mail address
- Examining message initiation protocol (HTTP, SMTP)
- Examining Message ID
- Examining sender's IP address

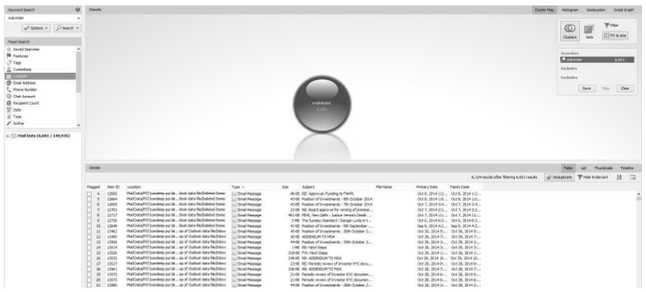
4.1 Following are the Steps to be Carried out for Forensic Analysis of E-mails

5. When we receive e-mail dumps in nsf (notes storage facility), eml (e-mail in file forms), pst(personal storage table) or ost format (offline folder file) the first step is to index the mails using a digital forensic tool called Intella (product of Vound Technology). Intella is widely regarded by investigators across industries as the best in class e-mail review tool for its powerful and comprehensive indexing of e-mail data sources. These sources include (but are not limited to): Microsoft Outlook PST/OST, Versions: 97, 98, 2000, 2002, 2003, 2007, 2010, 2013 and 2016; Microsoft Outlook Express DBX, MBX, Versions: 4, 5 and 6; Microsoft Exchange EDB files, Versions: 2003, 2007 and 2010; IBM Notes NSF (formerly known as Lotus Notes or IBM Lotus Notes; Mbox; Saved e-mails (.eml,.msg); Apple Mail (.emlx); TNEF-encoded files ("winmail.dat" files); and Bloomberg XML dumps.With Intella, investigators seamlessly capture e-mail data in two variants, in both pure and rich text, enabling reviewers with the ability to process e-mail as it appears in the native client and ensuring the most comprehensive review of your data source are captured, including inline images and other graphic alterations.

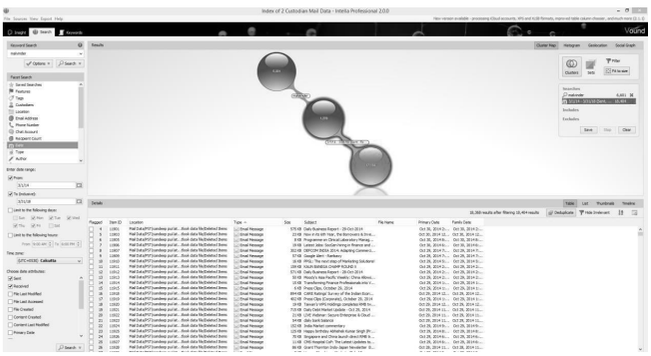
The typical GUI for Intella during indexing looks as follows:



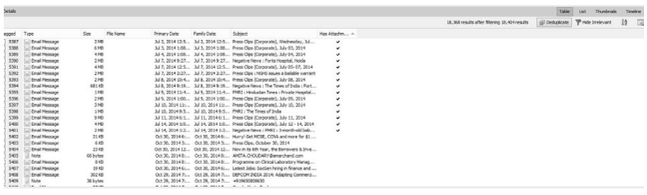
6. The Indexing helps in performing all types of Keyword searches in a quick and effective way. One can search a keyword individually or can also perform joined keyword search on the index using "AND" and "OR". The following figure shows the result for a generic keyword Search.



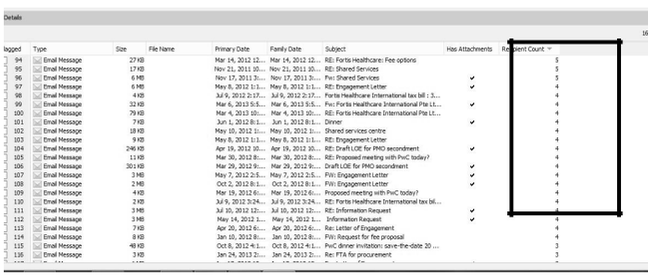
7. We can search e-mails between a given time period as shown below.



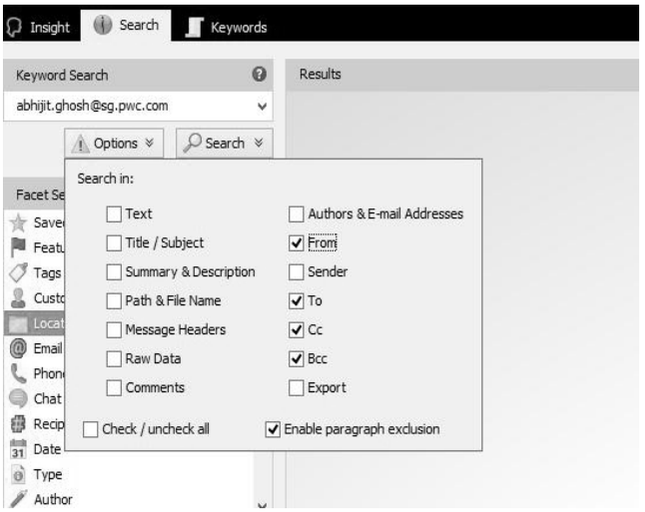
8. It is also possible to segregate e-mails that contain any kind of attachments from those that don't contain any attachments. The figure below shows the same



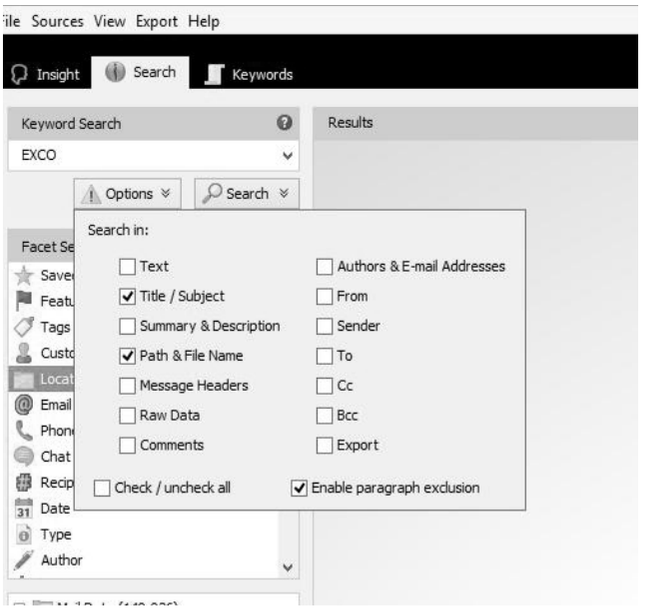
9. We can also find out one-to-one, one-to-many communications.



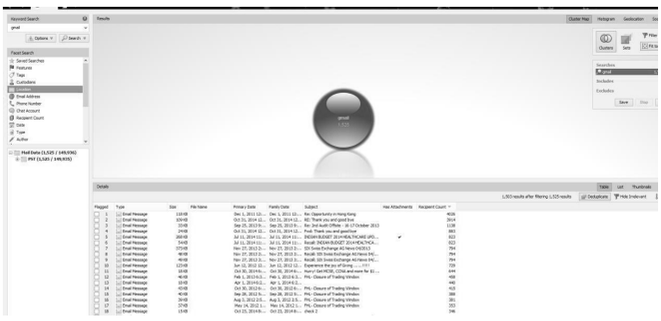
10. We can get also get e-mails that were specifically sent to or received from an e-mail ID.



11. The keyword search can be limited to specific parts of the e-mail like to search only within subject part or search only within the body part of the mail.



12. One can also search for mails that sent to or received from any outer domain IDs (gmail, yahoo, Hotmail etc.).



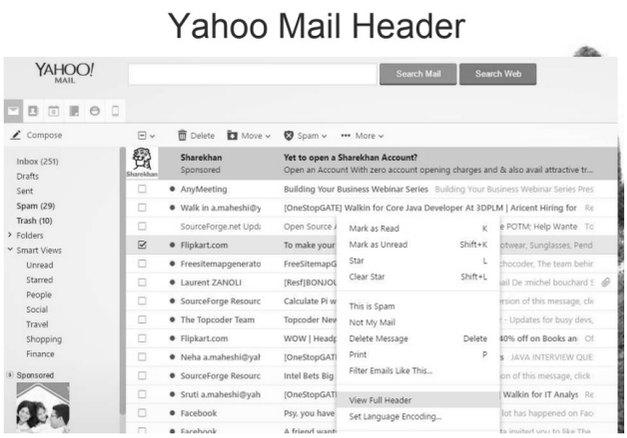
13. Intella can also be used to convert the provided E-mail dumps into PST format. Consider an instance in which there are about 10000 mails out of which 100 contain a keyword named "Cash". In this case one run the keyword, and then one can export the results in different formats like 100 message files or 100 EML files or a single PST file.

14. It is also possible to merge all the PST files of a single user into a single PST file. Consider an instance in which there are have about 10000 mails out of which 100 contain a keyword named "Cash" and 100 mails contain the keyword "Property". In this case one run the keywords, and then export the results in a single PST file

4.1 E-mail Headers and its Analysis

Meta data in the e-mail message in the form of control information i.e. envelope and headers including headers in the message body contain information about the sender and/ or the path along which the message has traversed.

In order to check the header information of a mail; select that mail and then right click and then click on "View full Header". The picture given below is for mails from Yahoo, for other service providers it will be different.



The following table gives a brief description of each of the fields present in the header:

Header Field Name	Description
From	The e-mail address, and optionally the name of the author(s).
To	The e-mail address(es), and optionally name(s) of the message's recipient(s).
Cc	Carbon copy
Bcc	Blind Carbon Copy
Subject	A brief summary of the topic of the message.
Date	The local time and date when the message was written.
Message-ID	Address that should be used to reply to the message.
Reply-To	An automatically generated field, it uniquely identifies this message.
Received	Tracking information generated by mail servers that have previously handled a message, in reverse order.

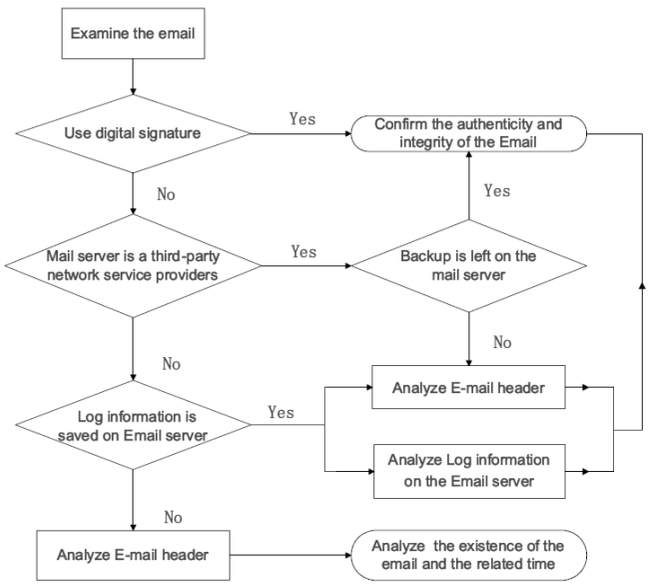
To determine whether an e-mail can be used as evidence, it is necessary to identify its authenticity and integrity. Generally, e-mail in dispute is divided into the following three conditions:

- Sender and/ or recipient do not admit send or receive the e-mail.

- Both parties have disagreement on the time of send and receive e-mail.
- Both parties have disagreement on the contents of the e-mail.

The ways of e-mail forgery is various, therefore, it is necessary to use e-mail authentication technology to find out the truth.

E-mail Identification Process



In addition, sending and receiving e-mail must follow certain protocol. One can identify the authenticity and integrity of e-mail according to the protocols. These protocols are complex, often using the POP3, IMAP and HTTP protocol to receive e-mail. The key of e-mail authenticity identification is to identify forged content, rule out the possibility of false information, and get real information.

The following figure shows a typical example of e-mail header.

```
Received: from corpease.net ([61.145.121.42])
by col0-mc2-f8.Col0.hotmail.com with Microsoft
SMTPSVC(6.0.3790.3959);
Fri, 9 Oct 2009 07:51:42 -0700
Received: from LENOVO806D10B5 (unknown
[124.79.135.160])
by mail37.corpease.net (Coremail) with SMTP id
KgGowJCb3lSCTc9KM+SKAA--.21072S2;
Fri, 09 Oct 2009 22:49:39 +0800 (HKT)
Message-ID:
<003501ca48ef$bca53e10$6664a8c0@LENOV
O806D10B5.c-insight.com.cn >
From: "helen zhang" <helen@c-insight.com.cn>
To: < chaney@hotmail.com >
Subject: solutions
Date: Fri, 9 Oct 2009 22:50:21 +0800
MIME-Version: 1.0
Content-Type: multipart/mixed;
boundary="----
=_NextPart_000_0026_01CA4931.9FD40D60"
X-Priority: 3
X-MSMail-Priority: Normal
X-Mailer: Microsoft Outlook Express
6.00.2900.3598
X-MimeOLE: Produced By Microsoft MimeOLE
V6.00.2900.3350
```

Assuming the e-mail has not been forged, from the analysis of time and time zone, we can find the e-mail delivery process is:

- LENOVO806D10B5(MUA)--Fri,9Oct 200922:50:21+0800
- mail37.corpease.net (MTA) or LENOVO806D10B5.cinsight.com.cn--Fri, 09Oct2009 22:49:39+0800 (HKT)
- col0-mc2-f8.Col0.hotmail.com-MTA---Fri, 9Oct2009 07:51:42 -0700
    - Analysis according to the mail delivery time:

In step 1, the e-mail transmission time is October 9, 2009 22:50:21 (time zone is + 0800, the Chinese coast time), while in step 2,

time becomes October 9, 2009 22: 49:39 (time zone is +0800, Hong Kong SAR time), the last received time is October 9, 2009 07:51:42 (time zone is -700, the U.S. Mountain time). Unify the time zone, then the received time is October 9, 2009 22: 51:42 (time zone is + 0800). Here we can find a time dislocation that seems the e-mail is into a time warp. Reasonable interpretation is one of the following possibilities:

- System time of step 1 to step 3 is not a standard time, there are some error with the server (time error is little);
- From step 1 to step 3, the e-mail header is forged.

According to the e-mail header, Message-ID is0 03501ca48ef$bca53e10$6664a8c0@c-insight.com.cn; XMailer is Microsoft Outlook Express 6.00.2900.3598.Through conversion of the Message-ID, we can find the e-mail was delivered on October 9, 2009 14:48:30, Friday, after reunification of the time zone, the time is October 9,2009 22:48:30. Through the above analysis we can conclude that if the Message-ID is not forged, then the e-mail headers in step 1 is forged, or the system time in step 1 is not standard time.

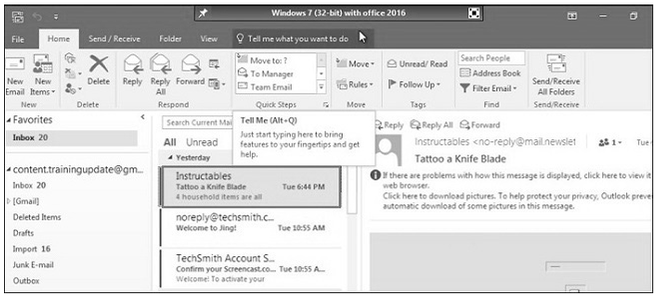
4.1 Viewing MS Outlook Header

Microsoft Outlook is one most leading e-mail clients used at a business level in many organisation. The users share every kind of information in an organisation by sending messages to each other. Most of the times users share their organisation's important data over MS Outlook. Therefore, when someone receives an e-mail over Outlook, it not only contains content or any attachment but also contains some information in the E-mail Header. This Outlook header information is very important from the forensic point of view. The lines of metadata i.e. data about data are included in each e-mail are e-mail headers. They contain lots of important information for forensic investigators. It is basically a special kind of field added by the server automatically known as e-mail header. Therefore, Outlook e-mail header analysis is very helpful because it contains the data such as contact information or route information that can be a part of the evidence in cyber crimes also. Analysis of Outlook e-mail header can play a major role in understanding the route of e-mail messages and identify the e-mail spamming and spoofing. These types of information can easily be traced by the analyzing any manipulation in the headers of senders and receivers. If there are any manipulation or changes present in the e-mail message header then it is clear that there is some manipulation in the e-mail. Therefore, Outlook e-mail header analysis plays a very crucial role in tracking all the details related to a particular e-mail. In the following Section, the complete guide to Microsoft Outlook e-mail message header analysis is discussed.

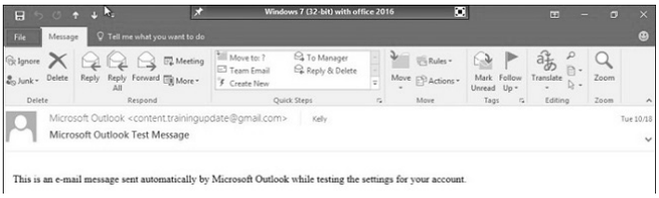
How to View E-mail Header in Outlook?

The user of Microsoft Outlook can easily view complete e-mail header that is attached to each e-mail to get detailed information about the received e-mail. As headers are not normally visible to a user in actual e-mail. Therefore, one can read e-mail header in Outlook 2010 and all other versions by following the steps mentioned below:

- First of all, open MS Outlook application on your system
- Now, select the message and double click on it for which you want to read e-mail header

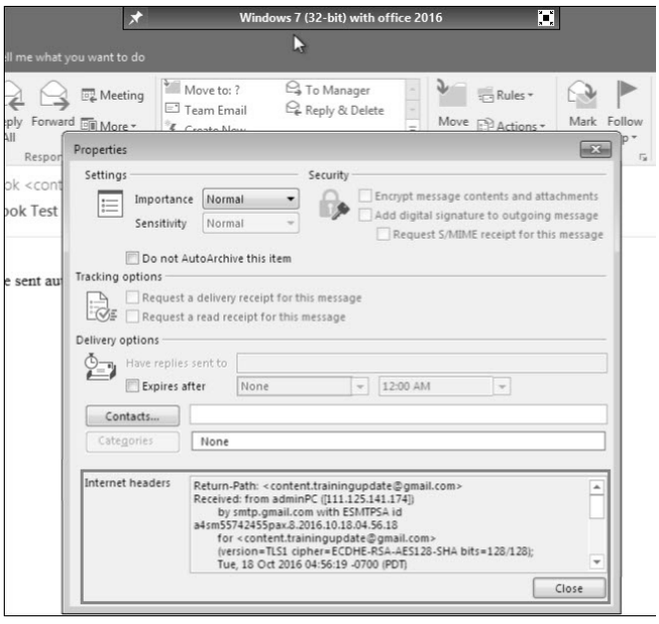


After opening the message, go to File tab



- Now, in the File tab click on the Properties option

- You can easily view the e-mail header related to particular message in Internet Header box



With the help of these manual steps, a user can view easily and read header in Outlook for a particular e-mail. Moreover, forensic investigators can also read these and perform analysis accordingly.

Microsoft Outlook E-mail Header Analysis

After reading complete header in Outlook there is a need to understand the purpose or significance of each header in the e-mail. Therefore, in this Section, a complete e-mail header forensic of Outlook is discussed.

Email Header of Outlook

```
Return-Path: <content.trainingupdate@gmail.com>
Received: from adminPC ([111.125.141.174])
      by smtp.gmail.com with ESMTPSA id a4sm55742455pax.8.2016.10.18.04.56.18
      for <content.trainingupdate@gmail.com>
      (version=TLS1 cipher=ECDHE-RSA-AES128-SHA bits=128/128);
      Tue, 18 Oct 2016 04:56:19 -0700 (PDT)
Message-ID: <58060de3.644e420a.7228e.e2aa@mx.google.com>
Date: Tue, 18 Oct 2016 04:56:19 -0700 (PDT)
From: "Microsoft Outlook" <content.trainingupdate@gmail.com>
To: "Kelly" <content.trainingupdate@gmail.com>
Subject: Microsoft Outlook Test Message
MIME-Version: 1.0
Content-Type: multipart/alternative;
      boundary="----=_NextPart_000_0000_01D22964.BA8F5630"
```

The above figure represents the complete e-mail header list of Microsoft that is attached in an e-mail.

Return-Path: The return-path e-mail header Outlook is mainly used for bounces. It describes the return-path of the message, where the message needs to be delivered or how one can reach to message sender. If the message is not delivered, then the mail server will send the message to the specified e-mail address.

Received: An essential e-mail header in Outlook 2010 or all other versions is received header. It displays the list of all the e-mail server through which message is routed to reach the receiver. Moreover, the best way to analysis this header is read it from bottom to top.

This header also provides the information about the message that is when the message is transferred for example in above header it specifies that it occur on Tuesday, October 18, 2016, at 04:56:19 in the morning is Pacific Standard Time that is 8 hours late than UTC (Universal Coordinated Time).

This field also provides IP address of all the sender's mail server, receiver's mail server, and the mail server, through which message is passed from sender to receiver.

Message-ID: There is always a unique message id assigned to each message that refers to a particular version of a particular message. For example:

Message-ID:"58060de3.644e420a.7228e.e2aa@mx.google.com"

This message has a unique identifier (number) that is assigned by mx.google.com for identification purpose. It is the unique ID that is always associated with the message.

Date: As it is clear from the name, it specifies the date and time of a particular message that when the message was composed and sent. Moreover, this date and time are totally dependent on the clock of sender's computer.

From: The from e-mail header in Outlook specifies the name of the sender and the e-mail address of the sender. This header can easily be forged, therefore it is least reliable. For example:

From: "Microsoft Outlook" "content.trainingupdate@gmail.com"

It specifies that message was sent by Microsoft Outlook from the e-mail address content. trainingupdate@gmail.com

To: The "to" field in the Outlook e-mail header normally specifies the name of the receiver or we can say that to whom message was sent.

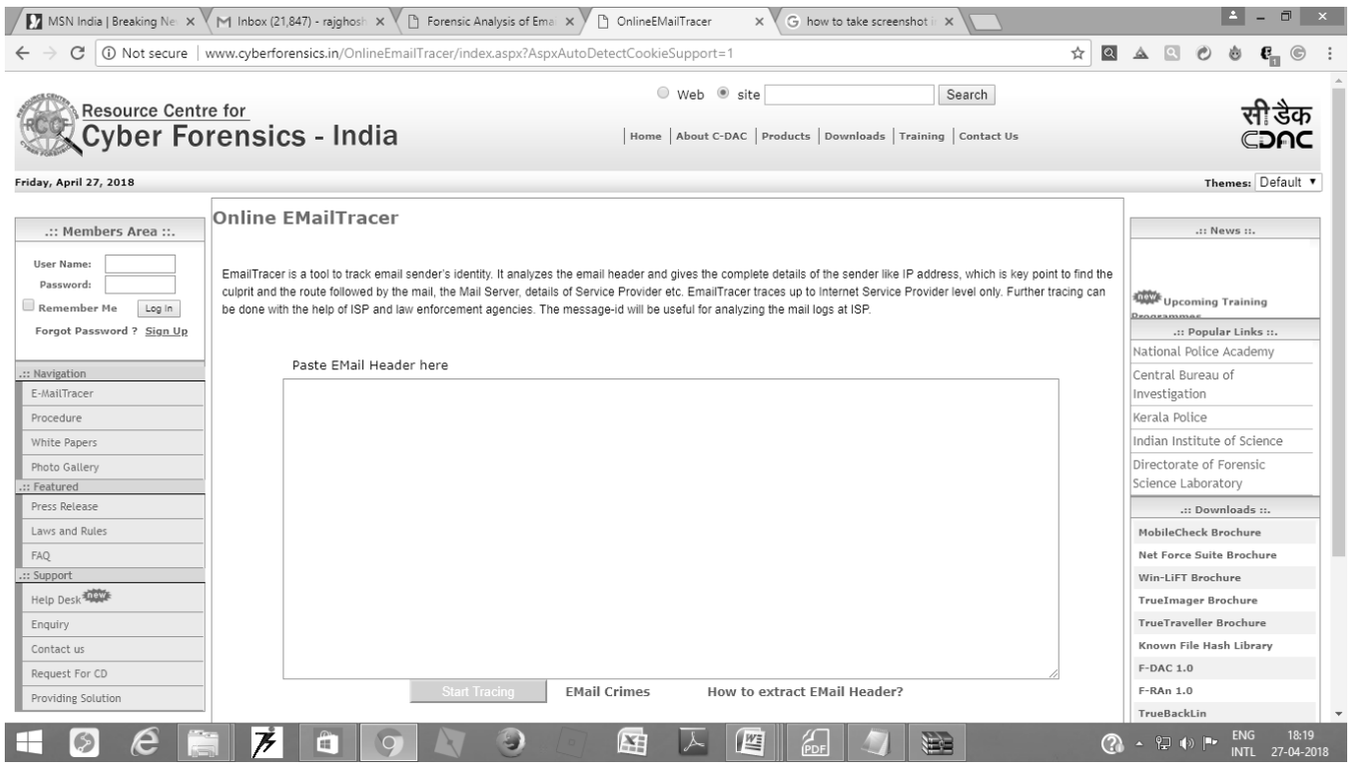
Subject: This header field normally displays the subject of the e-mail message which is specified by the sender of the e-mail.

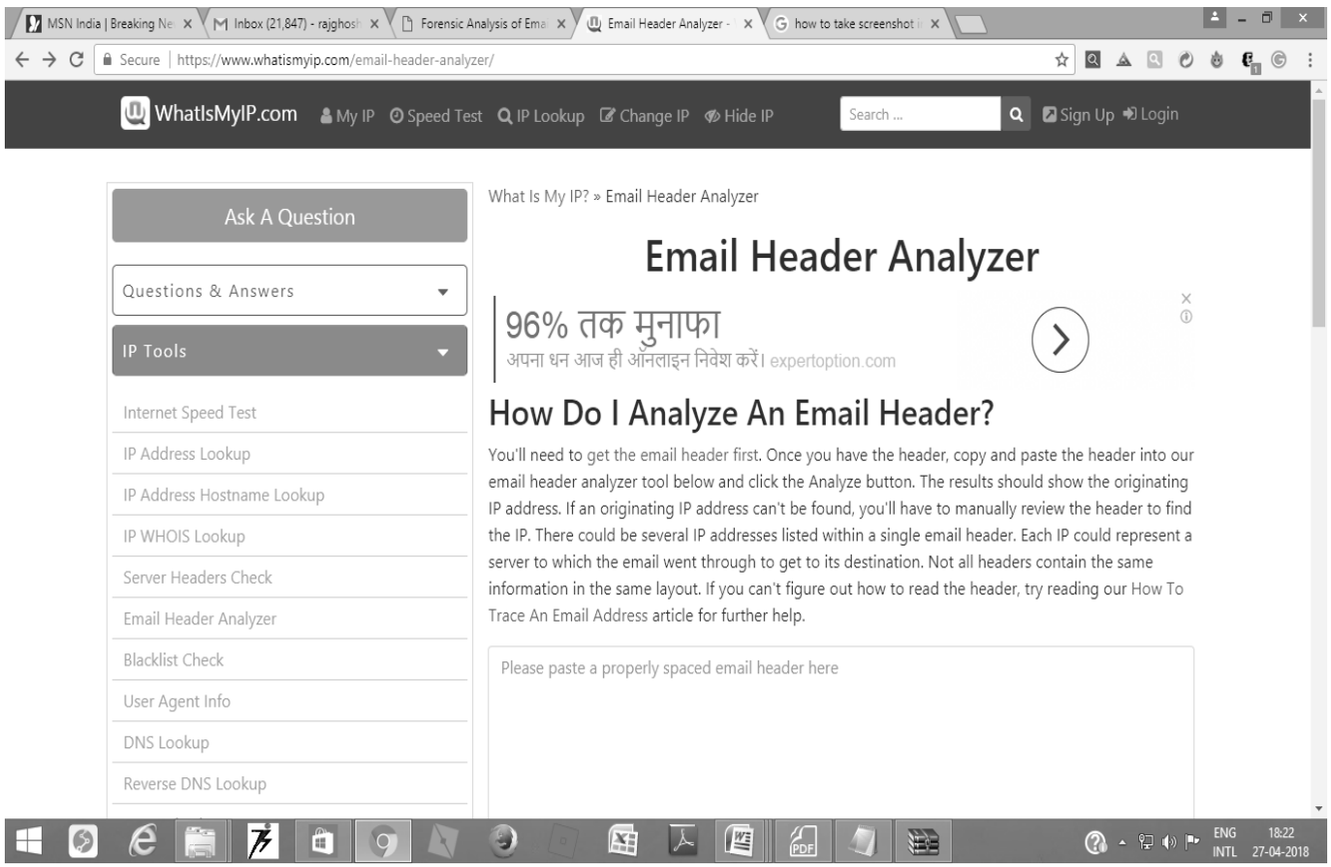
MIME Version: MIME is basically a Multipurpose Internet Mail Extension is an internet standard. Its role is to extend the e-mail message format. It also describes the version of MIME protocol that sender was using at that time. It is also an important e-mail header in Outlook.

Content-Type: It is an additional MIME header that tells the type of content to expect in the message with the help of MIME-compliant e-mail programs. It also displays the format of the message like HTML, XML and plain text.

There are certain open source tools which are available on certain websites which may help in carrying out e-mail header analysis. EmailTracer is a tool to track e-mail sender's identity. It analyzes the e-mail header and gives the complete details of the sender like IP address, which is key point to find the culprit and the route followed by the mail, the Mail Server, details of Service Provider etc. EmailTracer traces up to Internet Service Provider level only. Further tracing can be done with the help of ISP and law enforcement agencies. The message-id will be useful for analyzing the mail logs at ISP. (see the picture below)

There are websites which is helpful in this regard such as WhatismyIP.com. Once you have the header, copy and paste the header into our e-mail header analyzer tool below and click the Analyze button. The results should show the originating IP address. If an originating IP address can't be found, one will have to manually review the header to find the IP. There could be several IP addresses listed within a single e-mail header. Each IP could represent a server to which the e-mail went through to get to its destination.


Not secure | www.cyberforensics.in/OnlineEmailTracer/index.aspx?AspxAutoDetectCookieSupport=1
Resource Centre for
Cyber Forensics - India
Web site Search
Home | About C-DAC | Products | Downloads | Training | Contact Us
Friday, April 27, 2018
Themes: Default
.:: Members Area ::.
User Name:
Password:
Remember Me
Log In
Forgot Password ? Sign Up
.:: Navigation
E-MailTracer
Procedure
White Papers
Photo Gallery
.:: Featured
Press Release
Laws and Rules
FAQ
.:: Support
Help Desk
Enquiry
Contact us
Request For CD
Providing Solution
Online EMailTracer
EmailTracer is a tool to track email sender's identity. It analyzes the email header and gives the complete details of the sender like IP address, which is key point to find the culprit and the route followed by the mail, the Mail Server, details of Service Provider etc. EmailTracer traces up to Internet Service Provider level only. Further tracing can be done with the help of ISP and law enforcement agencies. The message-id will be useful for analyzing the mail logs at ISP.
Paste EMail Header here
Start Tracing
EMail Crimes
How to extract EMail Header?
.:: News ::.
Upcoming Training Programmes
.:: Popular Links ::.
National Police Academy
Central Bureau of Investigation
Kerala Police
Indian Institute of Science
Directorate of Forensic Science Laboratory
.:: Downloads ::.
MobileCheck Brochure
Net Force Suite Brochure
Win-LiFT Brochure
TrueImager Brochure
TrueTraveller Brochure
Known File Hash Library
F-DAC 1.0
F-RAn 1.0
TrueBackLin


Secure | https://www.whatismyip.com/email-header-analyzer/
WhatIsMyIP.com
My IP
Speed Test
IP Lookup
Change IP
Hide IP
Search ...
Sign Up
Login
Ask A Question
Questions & Answers
IP Tools
Internet Speed Test
IP Address Lookup
IP Address Hostname Lookup
IP WHOIS Lookup
Server Headers Check
Email Header Analyzer
Blacklist Check
User Agent Info
DNS Lookup
Reverse DNS Lookup
What Is My IP? » Email Header Analyzer
Email Header Analyzer
96% तक मुनाफा
अपना धन आज ही ऑनलाइन निवेश करें। expertoption.com
How Do I Analyze An Email Header?
You'll need to get the email header first. Once you have the header, copy and paste the header into our email header analyzer tool below and click the Analyze button. The results should show the originating IP address. If an originating IP address can't be found, you'll have to manually review the header to find the IP. There could be several IP addresses listed within a single email header. Each IP could represent a server to which the email went through to get to its destination. Not all headers contain the same information in the same layout. If you can't figure out how to read the header, try reading our How To Trace An Email Address article for further help.
Please paste a properly spaced email header here

CHAPTER

16

Cordination with NCLT and Taxability Issues

1. INTRODUCTION

1.1 In order to tackle the recurring problem of stressed assets, which adversely affects the health of the economy, there are non-statutory mechanisms in place including Bilateral Restructuring, Corporate Debt Restructuring (CDR), Joint Lenders' Forum (JLF), Flexi Restructuring Scheme, Change of management through Strategic Debt Restructuring (SDR) and change of management outside of SDR and Scheme for Sustainable Structuring of Stressed Assets (S4A) which were based on various circulars of RBI.

1.2 Further, Banks have devised several other mechanisms for dealing with stressed assets like using the provisions envisaged under *Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFESI) Act, 2002* in respect of mortgaged assets and *Debt Recovery Tribunal(DRT)* in respect of other assets and personal guarantees of director. Apart from these modes of recovery of stressed assets, restructuring of loans, one time settlements and sale of loans to ARCs (Asset Reconstruction Company) are also used.

1.3 Now, RBI vide circular dated 12.02.2018 asked banks to classify stressed accounts as Special Mention Account (SMA). RBI gave 180 days window to agree to resolution plan, failing which an account has to be referred to insolvency court.

Stressed Assets can be denoted as follows:

Stressed assets =*NPAs + **Restructured loans + Written off assets

*Non Performing Assets or NPAs are loans which have not been repaid during a specified time period (90 days).

**Restructured assets are those for which Banks have provided extended repayment period, reduced interest rate, converted outstanding loans into equity, etc.

2. CONSTITUTION OF NCLT

2.1 The Central Government has constituted National Company Law Tribunal (NCLT) under Section 408 of the Companies Act, 2013 (18 of 2013) with effect from 01st June 2016.

National Company Law Appellate Tribunal (NCLAT) was constituted under Section 410 of the Companies Act, 2013 for hearing appeals against the orders of NCLT, with effect from 1st June, 2016.

In the year 2016, Insolvency and Bankruptcy Code (IBC) was enacted to help banks in expediting recovery from stressed assets. Adjudicating authority in relation to insolvency resolution and liquidation for corporate persons including corporate debtors and personal guarantors is NCLT as per Sections 5(1) and 60 of IBC. NCLAT is the Appellate Tribunal for hearing appeals against the orders passed by NCLTs under Section 61 of the IBC. NCLAT is also the Appellate Tribunal for hearing appeals against the orders passed by Insolvency and Bankruptcy Board of India under Section 202 and Section 211 of IBC.

Presently, 11 benches of NCLT are constituted and functioning being one Principal Bench at New Delhi and ten Benches at New Delhi, Ahmadabad, Allahabad, Bengaluru, Chandigarh, Chennai, Guahati, Hyderabad, Kolkata and Mumbai. These Benches are headed by the President, 16 Judicial Members and 09 Technical Members at different locations. Details of the same and jurisdiction of the respective benches is available on the website www.nclt.gov.in. The National Company Law Appellate Tribunal (NCLAT) is located at Delhi and is the appellate authority for filing appeals against the orders of NCLT.

3. PURPOSE OF NCLT AND SCOPE OF WORK

3.1 It is pertinent to note that NPAs increased from Rs.2.79 lakh crores as on 31.03.2015 to Rs.8.56 lakh crores on 31.03.2018, which is a 3.21 times increase in a period of three years.

3.2 Under IBC, National Company Law Tribunal (NCLT) is empowered to deal with the stressed assets in a time bound manner. Initially the attempt is made to transfer ownership of stressed borrower as going concern basis. This results in payments of loan and interest to the bankers with some haircut. If there is no suitor found, the NCLT orders liquidation of the company and assets are auctioned for payment of banks liabilities. From the above, it can be seen that there are two situations as a result of resolution of stressed accounts:

xv. Where assets are sold/ auctioned and proceeds are travelling against loans/ interest.

xvi. Banks recover debt/ interest through change in ownership or corporate debt restructuring or one time settlement.

3.3 The NCLT has the power under the Companies Act (among other things) to adjudicate proceedings pending before the *Board for Industrial and Financial Reconstruction* (BIFR), including those pending under the Sick Industrial Companies (Special Provisions) Act, 1985 pertaining to;

1. Claims of creditors of a company
2. Winding up of companies.
3. Schemes of amalgamation, merger, demerger and restructuring of companies.

4. PROCESS FOR (INSOLVENCY RESOLUTION) IN IBC/ NCLT

4.1 Under Insolvency and Bankruptcy Code 2016, Banks and other creditors can speedily and in time bound manner resolve their stressed assets. This process involves maximum 270 days within which the stressed assets have to be resolved otherwise NCLT has to send the defaulting company into liquidation. Under IBC 2016, the following steps are taken in resolution of stressed assets:

i. Application for insolvency to be filed under Section 7 of IBC before NCLT by

Financial Creditors, Operational Creditors or even defaulting depositors or employee association in case of default of more than Rs. 1,00,000.

ii. NCLT passes order admitting the Petition within 14 days and Resolution Professional is appointed. With this, process under IBC commences and moratorium on the debtors operations *u/s* 14 starts. This operates as 'calm period' during which no judicial proceedings for recovery, enforcement of security interest, sale or transfer of assets or termination of essential contracts can take place against the debtor.

iii. After admission of the petition, Resolution Professional invites claims from all creditors and forms Committee of Creditors under whose supervision and guidance, Resolution Professional will function.

iv. Resolution Professional invites prospective resolution applicants by providing necessary information.

v. Virtual Data Room is setup by Resolution Professional wherein relevant information, data & documents are provided to applicants.

vi. Two Registered Valuers are to be appointed by Resolution Professional to ascertain liquidation value.

vii. Further, appointment of Committee of Creditors' (COC), Evaluator and Legal Advisor is made to assist them in evaluating the resolution proposals along with legal diligence.

viii. On receipt of Resolution Plan, the same is put up to COC for evaluation and decision.

ix. Resolution Plan is discussed and evaluated in COC meeting and highest bidder (H-1) is decided.

x. Negotiations and consultation is held by COC and their representatives with H-1 applicant to improve and clarify it's resolution plan.

xi. After discussions and consultations, Addendum is submitted by H-1 resolution applicant.

xii. After considering the complete resolution plan, letter of intent is issued to H-1 resolution applicant.

xiii. Resolution plan is approved by NCLT if the same fulfils all the conditions mentioned in Section 30 of IBC 2016. If the resolution plan is not accepted within 270 days (180+90), the NCLT orders liquidation of the company.

xiv. Monitoring agency appointed by COC and approved by NCLT to complete the Resolution Process.

4.2 The above process is followed in all cases where resolution in the case of company is sought for. In IBC, the priority of claim has changed as compared to BIFR. Govt. dues are now considered as operational creditors and their priority for re-payment is even after unsecured financial creditors. The entire process of resolution/ liquidation in IBC is driven by Committee of Creditors.

4.3 As regards insolvency resolution process for individuals and partnerships, the code applies in all cases where minimum default amount is Rs.1,000/ - and above. The code envisages two distinct processes in case of insolvencies: automatic fresh start and insolvency resolution. In automatic fresh start process eligible debtors can apply to DRT to discharge from certain debts, allowing them to start afresh. The insolvency resolution plan consists of preparation of repayment plan by the debtor for approval of creditors. If approved, the DRT passes an order binding the debtors and creditors to repayment plan. If the plan is rejected, the debtor or creditors may apply for bankruptcy order.

5. REPRESENTATION BEFORE NCLT

5.1 NCLT courts update their official website www.ibbi.gov.in on daily basis with regard to initiation of insolvency and liquidation proceedings against the companies under the IBC 2016. The list of cases is available under the icon 'Public Announcement' on this website.

5.2 The details of AO etc. is identified from the PAN directory by NCLT and notification is sent to Pr. CCIT concerned on their designation based official e-mail id on daily basis. The AO is expected to check official e-mail id to identify the case admitted by NCLT pertaining to his jurisdiction.

5.3 In relation to cases of sanction of schemes related to restructuring of companies through amalgamation, merger and demerger an opportunity is necessarily provided to the Income-tax Department to file its objection to the scheme within a specified period.

5.4 CBDT vide its various notifications has directed that NCLT cases should be attended with spirit and should not be left unrepresented. The representation of cases before NCLT may be assigned to counsels out of the existing empanelled Senior Standing Counsels of the region concerned. Further, if there is no Senior Standing Counsel for any particular region, Junior Counsels may be requested to represent the cases before NCLT. It has also been directed that in case there is a requirement of empanelling Senior Standing Counsels in the region in view of the pendency before NCLT, a proposal may be sent to the Board in accordance with Board's Instruction No. 7/2016 date 07.09.2016 read with letter F.No.279/ Misc/ M-77/ 2011-ITJ(Part-3) date 17.10.2017.

5.5 The PCCIT in whose jurisdiction the NCLT bench is situated shall obtain details of pending Income-tax Matters, from the registry of NCLT Bench forthwith and keep updating the same to ensure that such cases do not go unrepresented. Such details of pending cases obtained by the PCCIT where the bench is situated, shall be communicated to other PCCIT regions covered by the said bench to ensure representation.

5.6 The CBDT has directed the Assessing Officers to notify the demands due from sick companies to the resolution professionals and insolvency professionals. Further, it has also directed field formations to request the NCLT to make the department a party in all cases where tax relief was proposed under the resolution plan.

6. DESIGNATION OF NODAL OFFICERS

The Board vide its notification F. No. 278/ M-52/ 2003-ITJ-(Pt) dated 04.04.2018 has clarified that the Pr. CCIT is the designated Nodal Officer of the Income-tax Department for receipt of communication from NCLAT & NCLT benches. The PCCIT of the region where the particular benches of NCLAT & NCLT is situated has been designated as the Nodal Officer. In case of a PCCIT region where the NCLT bench is not situated in the region,, the PCCIT concerned has been directed to ensure representation by coordinating with the Nodal PCCIT in whose jurisdiction the NCLT bench is located. The Nodal PCCIT will ensure representation before NCLT by coordination with the jurisdictional PCCIT. This assumes importance in view of the fact that in case of many NCLT benches, a single bench covers the territorial jurisdiction of more than one PCCIT region. (Reference F.No. 278/ M/ 52/ 2003-ITJ(Pt.) dated 08.11.2017.

7. PROCEDURE FOR LODGING CLAIMS BEFORE NCLT

i. Accessing the IBBI site (http://www.ibbi.gov.in)

ii. Go to the public announcement Button/ Icon (http://ibbi.gov.in/webfron/public announcement.php)

iii. Choose the option of insolvency resolution/ voluntary liquidation/ liquidation whichever is applicable (http://ibbi.gov.in/ webfront/public announcement.php)

iv. Clicking on column No. 7 of public announcement to know the e-mail id of professionals (http://ibbi.gov.in/webadmin/ pdf/announcement/2017/Sep/FORM%20 A%20MALABAR%20HOTELS%20 Private%20Limited.pdf)

v. Form Go the downloads on the home page to download the applicable form and also http://www.ibbi.gov.in/downloadform. html (Form B)

vi. Fill up the form and enclose proof of claim i.e. copy of assessment order/ penalty order etc and e-mail/ speed post the filled up form with proof to the insolvency professionals/ liquidator.

8. CHECK LIST FOR AO

1. Go to official e-mail id & check for cases admitted by NCLT.
2. Download Form B.
3. Complete Form B and Proofs of Demand.
4. Lodge with NCLT.
5. In all old cases check up with NCLT to see and confirm, if any claim is yet to be lodged or remained unrepresented.
6. Ensure representation whenever the cases are fixed for hearing.
7. Keep up updating claims.
8. Ensure timely filing of objection to the scheme of restructuring of companies through amalgamation, merger and demerger in appropriate cases.
9. The orders of NCLT have to be carefully examined and in case the order of the NCLT is not acceptable to the Department then appeal has to be filed to NCLAT. The time limit for filing appeal to NCLAT is 30 days from the date of the orders of the NCLT. *Thus it must be ensured that the decision on the NCLT order is processed well in time.*

9. TAXATION ISSUES: IN THE CASE OF LENDERS, BORROWERS AND SHAREHOLDERS IN BORROWING COMPANY

Relevant issues on account of such sale of assets or change of ownership or settlement of loans will have necessary implications from income-tax point of view in the hands of borrowers as well as lenders and shareholders in borrowing company which are discussed below.

9.1 In the Hands of Lenders

9.1.1 In the case of lenders, NPA provision is created immediately after non-payment of interest up to 90 days. The said provision is claimed under Section 36(1)(viia) and 36(1) (vii) of the Income-tax Act. Any recovery out of provisions allowed/ bad-debt claimed will result in write-back, and will be taxable under Section 41 of the Income-tax Act, 1961. Similarly, interest recovered from the date of NPA is also chargeable to tax. Assessing Officers of banks should examine the NPA account on recovery and ensure that write-backs and interest received are taken as income.

9.1.2 In case bank converts loan/ interest into equity, provisions of Section 56(2)(x) will be applicable and difference between fair market value of shares on the date of conversion and consideration paid/ adjusted will be treated as deemed income.

9.1.3 Some of the aspects which may require Assessing Officer's attention are as below:

j. Write back to be taxable *u/s* 41(1) of IT Act over and above the claim of provisions/ Bad debt allowed.

k. Overdue interest received on resolution taxable in the year of resolution.

l. Deduction *u/s* 36(1)(vi) r.w.s 36(1)(viia) and 36(2)(v).

m. Deemed income *u/s* 56(2)(x) if conversion of debt into equity or fresh allotment of shares are not at fair market value.

9.2 In the Hands of Defaulting Borrowers

9.2.1 In the case of restructuring of loans/ change in ownership and one time settlement, etc. there is always a waiver of part of the loan amount and interest. The new owner purchases shares which are subjected to taxation on the basis of market value. Accumulated losses of the Borrower Company are allowable subject to some restrictions. MAT provisions under Section 115JB also attract liability on credit of loan/ interest waived amount.

9.2.2 All these issues will require the Assessing Officer's attention which are summarised as below:

a. Waiver of loan *u/s* 2(24)(xviii), 28 and 28(iv).

b. Waiver of interest claimed/ allowed *u/s* 41(1).

c. Waiver of loan taken for fixed assets to be reduced from Actual Cost under Section 43(1).

d. Capital gain *u/s* 50 in case of sale of assets on liquidation of the company.

e. Capital Gain *u/s* 50CA in case of allotment of shares at less than FMV.

f. Carry forward of losses allowed *u/s* 79 even if Majority Share holders do not continue.

g. Reduction of accumulated losses and unabsorbed depreciation from

h. Book Profit *u/s* 115JB.

9.2.3 Some of the Specific Provisions of Income-tax Act with Reference to Aforesaid Transactions are Discussed Below

i. Addition under Section 28(iv)

Section 28(iv) of the Act deals with a benefit or perquisite, which arises from the exercise of a business or profession. The said provision comes into play when a benefit arises from normal incidence of business i.e. there is a positive inflow otherwise than in monetary terms.

In the context of waiver of loan amount, what follows from the judicial precedents is that the answer would depend upon the purpose for which the loan has been taken. A loan can be taken for the purchase of a capital asset, for the purpose of working capital or for business. Therefore, the chargeability of waiver of loan depends upon the nature for which the loan was taken.

The Madras High Court in the case of Iskraemeco Regent Limited (331 ITR 317) observed that it is a well-established principle of law that every deposit of money would not constitute a 'trading receipt'. Broadly, though a receipt may be in connection with business, it cannot be said that every such receipt is a trading receipt. Therefore, the amount referable to the loans obtained by the assessee towards purchase of capital asset would not constitute a trading receipt. However, the Madras High Court in the case of *CIT vs. Ramaniyam Hotels Pvt. Ltd.* (68 Taxmannn.com 289) differed from its aforesaid co-ordinate bench ruling and held that waiver of principal portion of the term loan should

have been taxable under Section 28(iv) of the Act. The High Court dissected the language used in Section 28(iv) to hold that the benefit may not arise from 'the business' of the taxpayer, but it certainly arose from 'business'. The High Court observed that there was no distinction between waiver of loan taken for acquiring a capital asset and waiver of loan taken for trading activities in accounting practice, and that such waiver would either be credited to profit and loss account or to the capital reserve.

If the loans are obtained for working capital purpose, waiver of the same may be taxed as business income. The Delhi High Court in the case of Ligitronics Pvt. Ltd., (333 ITR 386) has held that if a loan taken for trading purpose, is treated as such from the very beginning in the books of accounts, the waiver thereof may result in income, more so when it was transferred to the Profit and Loss account. In arriving at the said conclusion, the Delhi High Court relied upon the decision of the Supreme Court in the case of T.V. Sundaram lyengar & Sons Ltd., (222 ITR 344).

In the decision of the Supreme Court in the case of CIT v/ s Mahindra and Mahindra Ltd, while deciding the departmental appeal on account of addition on loan waiver which were taken for capital assets, it was held that addition on account of loan waiver cannot be made under Section 28(iv) in case of monetary benefits. It was held by the court that only those benefits which are convertible into money or not arising from business are allowable. This case relates to capital assets acquired out of loans taken.

ii. Reduction from the Relevant Block of Assets

In certain cases, the AOs have taken a view that the waiver of loan, to the extent they are capital in nature, must be reduced from the relevant block of assets. This would have the effect of reducing the quantum of depreciation allowable to the taxpayer of the relevant block for the subsequent assessment years. The Delhi High Court in the case of *Steel Authority in India Ltd. vs. CIT*, (20 Taxmannn.com 198) held that the taxpayer's action of reducing the amount of loan waived from the block of assets in their books of accounts shows that there is a belief that the subsequent waiver is towards meeting a part of the cost of assets. Hence, it was held that the waiver cannot have a different treatment for tax purposes and should be reduced from the relevant block of assets.

In this regard, reference may be made to judicial precedents to contend that the amount of liability waived off may not be reduced from the block of asset so long as such a treatment has not been made for accounting purposes in the books of accounts.

iii. Non-payment of Interest under Section 43B

Section 43B of the Income-tax Act provides that deduction of certain payments would be made only on actual payments. Interest to scheduled bank is allowable only on payment basis as per Clause (d) and Clause (e) to Section 43B. In case, the interest has been converted into loan, it will not be deemed to be actually paid since the liability to pay still remains. However, Delhi High Court in the case of Rathi Graphic Technology Ltd. (ITA no 780/ 2014) held that conversion of portion of interest into equity shares would be taken as actual payment under Section 43B. Therefore, assessing officer should consider conversion of interest into loan/ equity while deciding assessee's claim in this regard.

iv. Taxability of Waiver of Loan under Section 41(1)

Section 41(1) of the Income-tax Act deals with tax implication arising out of business or profession. As per this Section, if an assessee claimed a deduction of any loss or expense in current Financial Year or in any earlier year and has obtained waiver in respect of trading liability, the amount of benefit will become taxable under

Section 41(1). Therefore if interest on loan has been claimed in earlier years, waiver in respect thereof is taxable under Section 41(1) of the Act.

v. Carry Forward of Losses of Defaulting Borrowers

Section 79 of the Income-tax Act provides that the losses cannot be carried forward if majority shareholding in a company changes hands. However, in the case of any company under IBC, exception has been made under Section 79 that there is no requirement of ownership of major shareholding. The effect of this amendment is that the borrower company can continue to carry forward business losses and unabsorbed depreciation in case of change in ownership beyond 50% also.

vi. Amalgamation of Stressed Companies with Another Companies

Section 72A of the Income-tax Act provides for benefit of carry forward of accumulated losses and unabsorbed depreciation of companies. To get this benefit, two conditions must be met:

1. Surviving company must hold at least 75% of Book Value of fixed asset of merged company for minimum period of 5 years, and
2. Continue the business of stressed company for the period of 5 years.

If either of the conditions is not met, the loss and depreciation of the company are not allowable. Hence, the assessing officer has to continuously monitor the fulfilment of these two conditions for next 5 years from the date of such amalgamation.

vii. Capital Gain on Sale of Assets

In case the assets are sold, either on liquidation or otherwise, the defaulting borrower company will be subject to tax under Section 50 in respect of the depreciable asset and under Section 45 in respect of non-depreciable asset, if the consideration received is more than the W.D.V. or Book Value. The assessing officer should examine the chargeability of Capital Gain in all such sale of assets.

viii. MAT Provision under Section 115JB

Waiver of loan and interest under any debt resolution will result in credit of P&L account as per accounting standards. This will result in taxability of the defaulting company on enhanced Book Profit. By an amendment w.e.f. A.Y. 2018–19, all accumulated losses and unabsorbed depreciation are allowed from Book Profit. Therefore, if the reduction/ waiver of loan and interest are more than accumulated losses/ depreciation, net tax liability will arise. The assessing officer should examine each case resolved under IBC from this perspective.

9.2.4 Further, as regard applicability of Section 28, 28(iv) or 43(1), various arguments are given that by taxing or reducing waived loans from actual cost, a stressed company will further go into stress instead of revival. The additions in respect of working capital/ CC Loan waiver *u/s* 28/ 28(iv) r.w.s 2(24) (xviii) will only reduce the carry forward of losses and not require tax payment immediately till such time the entire brought forward losses and unabsorbed depreciation are exhausted. Only after the stressed company will start earning beyond such losses and depreciation, tax will be payable on such income. Therefore, the argument of giving further stress to the stressed company is not valid. The taxing of waiver of loan on trading activity only reduces unjust enrichment of such company. Tax liability will arise only after few years when the company will be completely out of stress and will be capable of paying taxes. The argument of taxing in favour of trade loan can also be seen in the light of the following example:

- The company purchased goods worth Rs. 15.00 crores. Out of this Rs. 5.00 crores was paid to the supplier through bank loans and remaining Rs. 10.00 crores was outstanding to the supplier on

the date of admission to NCLT under IBC 2016. The non payment to the supplier of Rs. 10.00 crores is taxable *u/s* 41(1) of the Act. Regarding Rs. 5.00 crores paid to the supplier which was also claimed as an expense, the company benefits on account of waiver of loan. Why the said benefit which has already been claimed as an expense should not be taxed *u/s* 28/ 28(1)(iv) of the I.T. Act?

The above example clearly demonstrates that the waiver of loan on account of trading activity should necessarily be taxed in the hands of the borrowing company.

9.3 In the Hands of Shareholders in Borrowing Company

Buyers and sellers of borrowing company's shares are subject to tax on transaction of shares at less than fair market value as under:

i. Application of Section 56(2)(x) and Section 50CA

Section 56(2)(x) provides for taxability in the hands of the recipient, on receipt of any sum of money or specified property (including shares) received without consideration or for inadequate consideration by any person. Consequently, if there is a part settlement or debt restructuring wherein the outstanding loans are converted into equity of the borrowed company at a price which is less than the fair market value of such shares, then the assessing officer has to impose tax on the difference between the consideration and the Fair Market Value of the securities.

Section 50CA imposes tax on the Notional Capital Gain on the Seller and Section 56 imposes tax on the Buyer. So, wherever change in ownership by transfer of shares has occurred, the assessing officer should examine the valuation of shares and take appropriate action in case of buyer under Section 56(2)(x) and in the case of seller under Section 50CA. In the case of *Sudhir K. Menon (HUF) vs. ACIT*, (162 TTJ 425), Mumbai Tribunal held that allotment of shares not in proportion to existing holding will result in taxability *u/s* 56(2) if transaction is not on fair market value.

10. CASE STUDY: NCLT RESOLUTION IN ONE OF THE LARGEST COMPANY

Sr. No	Particulars	Amount
1	Total Financial Creditors	Rs. 56,000 Crores.
2	Total Operational Creditors	Rs. 2,900 Crores.
3	Liquidation Value	Rs. 14,500 Crores.
4	Offer by highest bidder for Financial creditors and Operational creditors	Rs.36,000 Crores. Rs.1,200
5	Allotment of Equity Shares to the Company	80 Crores shares @ Rs. 2 per share
6	Market Price of share on closing date on NSE	Rs. 40 per share
7	Conversion of debt to equity and Fresh allotment of shares.	7.25 crores shares at Rs. 2 per share
8	Right for converting debt to equity subject to SEBI approval	4,500 Crores shares @ Rs. 2 per share
9	Duration of Resolution Plan	Immediate

Resolution applicant sought NCLT's approval for various reliefs and concessions which were not granted by NCLT. These are *u/s* 115JB, 281 etc of Income-tax Act apart from immunity from investigations and proceedings relating to prior period.

10.1 Tax Implication of the Case

Section 28(iv): Rs. 4000 crores on account of working capital and CC Loans on account of waiver of loan as per earlier decisions of High Courts and Apex court could be made prior to decision of the SC in the case of Mahindra & Mahindra Ltd. Now unless this decision is reviewed or Act is amended, addition will not be sustainable.

Section 41(1): Since there is cessation of trading liability to the extent of Rs. 1,700 crores on account of resolution (Rs. 2900 - Rs. 1200), the same will be added under Section 41(1) in the case of defaulting borrower.

Reduction from the Relevant Block of Assets: Rs. 16,000 Crores on account of Term loans for capital assets can be reduced from relevant block of assets considering the decision of the NTPC Ltd. referred earlier.

Under Section 56(2)(x): In case of acquiring company-more than Rs. 2,400 crores will be deemed income on account of difference between fair market value of equity shares and issue price of equity shares.

In case of future allotment of 4,500 crore shares out of conversion of loan, the tax liability will be determined on the basis of FMV on the date of conversion.

In the Case of Banks: Write-back of loans and interest received will be taxable on account of resolution. Further, conversion of debt to equity at a price less than Fair Market Value and deemed income on fresh allotment of 7.5 crore shares @ 38 per share (Market Price Rs.40 minus allotment price Rs. 2) Rs. 285 crores are taxable under Section 56(2)(x).

CHAPTER 17

Operation Clean Money

1. BACKGROUND

1.1 On 8th November 2016, the Government announced cancellation of legal tender character of all Rs. 500 and Rs. 1,000 banknotes except for a few specified transactions. The two high value denomination notes, constituted nearly 86% of cash in circulation on that date. The aim of the action were fourfold[1]: to curb corruption, counterfeiting, use of high denomination notes for terrorist activities, and accumulation of "black money" generated by income that has not been declared to the tax authorities. The action has been popularly referred to as demonetization.

1.2 Demonetization is one of the several measures taken by the Government in the last three and a half years to tackle the issue of black money. Some major initiatives in this regard, include the following:

- Constitution of the Special Investigation Team (SIT) on Black Money in May 2014
- Enactment of the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015
- Comprehensive amendment of the Benami Transactions (Prohibition) Act 1988
- Information Exchange Agreements with Switzerland
- Changes in the Tax Treaties with Mauritius, Cyprus and Singapore
- The Income Disclosure Scheme 2016
- The Taxation Laws (Second Amendment) Act, 2016 and the Pradhan Mantri Garib Kalyan Yojna, 2016

[1]Economic Survey 2016–17

2. OPPORTUNITIES AND CHALLENGES

2.1 One of the four objectives of demonetization was to curb the accumulation of "black money", generated by income that has not been declared to the tax authorities. With demonetization of high value currency notes, large amount of cash entered the formal banking system, which could be tracked through use of the know your customer (KYC) norms under the existing anti-money laundering regime This was an unprecedented opportunity for the Income-tax Department.

2.2 To enable tracking of these cash deposits, the Rule 114B of the Income-tax Act was amended in November, 2016 requiring all persons and entities to furnish their permanent account number (PAN) or Form No. 60 for all

accounts other than specified basic deposits/ accounts. The consequent linking of PAN with the bank accounts significantly enhanced ITD's ability to match the financial assets with the information received by the tax authorities post demonetization and later disclosed in the Income-tax returns.

2.3 The major challenge, however has been tracking of the entities, which managed to quickly move funds across multiple layers of bank accounts to obfuscate the source of funds. The table below presents the unique opportunities and challenges before the Income-tax Department (ITD) in identification of the fund trails.

Measure	Opportunity
Demonetization of high value denomination notes	Identification of persons depositing large amount of cash
Linking of PAN with bank accounts	Matching of financial asset with the information disclosed in the Income-tax Returns
Restriction on cash withdrawals	Tracking of funds and identification of layering accounts and entities

2.4 Investigations have shown that persons having unexplained old high denomination currency notes adopted a range of methods for conversion of such unaccounted cash into legal tender. Some such methods are:

- Splitting of cash deposit in multiple accounts
- Opening of new accounts to deposit cash
- Purchase of bullion, jewellery, luxury goods in cash
- Repayment of loan in cash
- Back-dating of cash sale transactions
- Inflation of cash-in-hand
- Exchange of notes before depositing in bank account
- Routing of funds through multiple accounts (using RTGS) through use of shell entities

As the nature of cash as black or white is fluid (e.g. sale of bullion, jewelry, luxury goods in cash converts unaccounted cash of purchaser as accounted cash in the books of accounts of the seller), investigation into all such cases require considerable effort and time.

Black or White: Fluid Categories

Cash can be used as a medium of exchange (for transactions) or as a store of value like other forms of wealth such as gold and real estate. In terms of nature, cash can be illicit or otherwise. Function and nature are quite distinct. For example, cash used as a store of value could be white (the savings that all households keep for an emergency), while cash used for transactions could be black (if it was earned through tax evasion and/ or corruption). Moreover, these categories are fluid. Cash held as black money can be converted to white through laundering and other means, or by declaring it to the authorities and paying the associated tax/ penalty.

(Reference: Economic Survey 2016–17)

3. IMMEDIATE RESPONSE

3.1 The Income-tax Department (ITD) took a series of steps between November 2016 and January 2017 for achieving the objectives of demonetization. These included strengthening of the data collection mechanism, collection of information on high value cash transactions from FIU-IND, preponement of the submission date to report Statement of Financial Transactions (SFT) to January 31, 2017 and focused enforcement actions.

Under the Statement of Financial Transactions (SFT), the banks and post-offices were required to report deposits aggregating to Rs.12.50 lakhs or above in case of current account and Rs. 2.50 lakhs or above in case of accounts other than current accounts, for the period between November 9, 2016 and December 30, 2016. For such reporting entities, similar cash deposits for the period April 1, 2016 to November 8, 2016 were also to be reported.

3.2 The Pradhan Mantri Garib Kalyan Yojana, 2016 (PMGKY) was launched on 17th December 2016. Declaration under the Scheme could be made by any person in respect of undisclosed income in the form of cash or deposits, in an account with bank or post office or specified entity. Such declarations followed by payments of specified taxes/ deposits entitled the declarants to immunity from penal consequences including criminal prosecutions.

4. BROAD APPROACH

4.1 Traditionally, the tax administration has emphasized on enforcement as a tool for ensuring compliance with the tax law. With the advent of information technology and the quantum leap in the number of taxpayers, tax administrations across the world have reformulated this strategy. The new strategy consists of a risk-based compliance management. Under this approach, the total taxpayer population is segmented into two broad categories, namely (i) those who intend to fulfill their legal obligations but do not have access to information and facilities to fulfill their legal obligations, and (ii) those who have access to information and facilities but do not intend to fulfill their legal obligations.

4.2 It has been Recognised that non-compliance amongst the first category of taxpayers can be significantly reduced by merely providing quality taxpayer services and facilitation, which do not require deployment of large resources. This allows the tax administration to release large resources for tackling a relatively small number in the second category (i.e. high risk persons). Use of new data-driven and intelligence led technologies can help tax administrations fine tune compliance approaches to incorporate appropriate interventions and develop new capabilities to address tax risks including tax avoidance, evasion and fraud.

4.3 In line with global experience, the Income-tax Department has adopted a multi-pronged strategy to achieve its objectives by launching numerous E-governance initiatives for:

ii. Providing tax payer services and facilitation;

iii. Establishing a robust risk management strategy to detect and penalize non-compliance; and

iv. Building internal capacity for efficient and faceless interface with all stakeholders.

5. OPERATION CLEAN MONEY

5.1 In line with the changing approach to ensure compliance, the Income-tax Department (ITD) initiated Operation Clean Money on 31st January 2017 with the launch of e-verification of large cash deposits made during 9th November to 30th December 2016. The mission of Operation Clean Money (OCM) was to "*Create a tax compliant society through a fair, transparent and non-intrusive tax administration where every Indian takes pride in paying taxes*".

5.2 The experience and learning of the initial phase of Operation Clean Money made it clear that a comprehensive strategic planning approach was needed to leverage the opportunities of demonetization and other measures for creating a tax compliant society.

5.3 The OCM Strategic Plan[2] identifies action points under following focus areas:

- OCM Focus Area 1: Citizen Engagement and Taxpayer Awareness
- OCM Focus Area 2: Quality Taxpayer Service Delivery
- OCM Focus Area 3: Timely Collection and Integration of Information
- OCM Focus Area 4: Leverage Data Analytics in Tax Administration
- OCM Focus Area 5: Supporting Voluntary Compliance
- OCM Focus Area 6: Transformation of Verification and Assessment Function
- OCM Focus Area 7: Effective Deterrence for Habitual Offenders

[2]Operation Clean Money Strategic Plan 2017–2022

- OCM Focus Area 8: Comprehensive IT enablement of Business Processes
- OCM Focus Area 9: Build and Strengthen Organisational Capacity
- OCM Focus Area 10: Develop Sustainable Compliance Ecosystem

6. E-VERIFICATION OF CASH DEPOSITS

6.1 The cash deposit data was analyzed to identify persons whose cash transactions did not appear in line with the taxpayer's profile. Preliminary assessment was undertaken to analyze distribution of large cash deposits across various taxpayer segments (e.g. Business, Non-business etc.). This analysis resulted in identification of about 17.92 lakh persons for verification process in the first phase.

6.2 Online verification of cash transactions was enabled and the information in respect of the identified cases was made available in the e-filing window of the PAN holder (after log in) at the portal https://incometaxindiaefiling.gov.in. The taxpayer was able to submit online explanation without any need to visit Income-tax office. Detailed user guide, quick reference guide and Frequently Asked Question (FAQs) were published to assist the taxpayer in submitting online response. Email and SMS were sent to the taxpayers for submitting online response on the e-filing portal. ITD also released advertisements to educate taxpayers about registration and submission of online response. There was an overwhelming response to the online verification process and nearly 11 Lakh persons submitted online response. More than 5.27 Lakh taxpayers submitted their response within 12 days.

7. IDENTIFICATION OF HIGH RISK CASES

7.1 ITD on-boarded two specialized data analytics agencies and a business process management agency to augment departmental capability in analyzing large volume of cash deposit data, and track the compliance status of taxpayers and reporting entities. Data analytics was used to identify high-risk cases such as:

- Persons/ groups splitting cash deposits in multiple accounts to avoid reporting
- High value cash deposit and purchase of property after demonetization
- High value cash deposit and outward foreign remittances after demonetization
- Clusters of non-PAN accounts with similar name and address
- Clusters of non-PAN accounts with similar name and mobile number

8. TARGETED ENFORCEMENT ACTIONS

8.1 A comprehensive and whole of the government approach was adopted to detect and punish those found involved in misuse of the scheme of demonetization. The enforcement actions intensified by the ITD led to significant incremental outcomes in terms of searches, surveys, and references of cases to the Enforcement Directorate and the CBI for further action.

9. SUPPORTING VOLUNTARY COMPLIANCE

9.1 The Portal of Operation Clean Money (https://www.cleanmoney.gov.in) was launched on 16th May 2017. The salient features of the OCM portal are:

- **Providing Comprehensive Information at One Place** consisting of Step-by-Step Guides, Frequently Asked Questions, User Guides, Quick Reference Guides and Training Toolkits related to verification process and other issues.
- **Enabling Citizen Engagement** for creating a tax compliant society where every Indian takes pride in paying taxes. Citizens would be able to support the operation clean money by taking pledge (इमानदारी का उत्सव), contribute by

engaging and educating fellow citizens (जन भागीदारी), and share their experiences and provide feedback (सुखद अनुभव).

- **Enabling Transparent Tax Administration** by sharing status reports (including sanitized cases and explanation of verification issues) and thematic analysis reports (e.g. taxpayer segment analysis of cash deposit data).

9.2 The web portal provides a platform for the citizens of India and Income-tax Department to come together for the common cause of building a proud nation, which runs on the strength of the honest taxpayer. Going forward, the portal is being leveraged as a tool to promote various programs and campaigns launched under OCM.

10. TARGETED ELECTRONIC CAMPAIGN

10.1 One of the pillars of Operation Clean Money is fair, transparent and non-intrusive tax administration. Keeping in view the large number of persons depositing cash, it was important to facilitate the taxpayers who intend to fulfill their legal obligations. The Income-tax return for the Assessment Year 2017–18 (Financial Year 2016–17) was modified to enable taxpayers to voluntarily provide the details of cash deposited in bank accounts aggregating to 2 lakh or more.

10.2 Targeted electronic communication and advertisement campaign were used to communicate to the target segment that they should:

- File the return by due date
- Mention the bank account in the Income-tax Return
- Consider the amounts so deposited while computing income and paying taxes.

11. COLLECTION AND INTEGRATION OF INFORMATION

11.1 The Income-tax Department collects taxpayers' financial transaction information from other entities under two broad categories i.e. Third party reporting obligation (under Section 285BA of the Income-tax Act) and Tax Deduction/ Collection at Source (TDS/ TCS). The following transaction types are collected under Statement for Financial Transactions (SFT) in Form 61A (Rule 114E).

- SFT- 001: Purchase of bank drafts or pay orders in cash
- SFT- 002: Purchase of pre-paid instruments in cash
- SFT- 003: Cash deposit in current account
- SFT- 004: Cash deposit in account other than current account
- SFT- 005: Time deposit
- SFT- 006: Payment for credit card
- SFT- 007: Purchase of debentures
- SFT- 008: Purchase of shares
- SFT- 009: Buy back of shares
- SFT- 010: Purchase of mutual fund units
- SFT- 011: Purchase of foreign currency
- SFT- 012: Purchase or sale of immovable property
- SFT- 013: Cash payment for goods and services
- SFT- 014: Cash deposits during specified period (9th Nov to 30th Dec, 2016).

11.2 The effectiveness of utilisation of third party reporting relies heavily on the quality of the data. Data errors and defects not only result in defects and errors during data analysis but also increase the compliance cost for a taxpayer. To overcome this, the department has provided a utility which allows the reporting entities to validate the information and identify errors before submission.

11.3 ITD is also developing a seamless system under Project Insight to assess the quality of data and identify the sources of error in it. The

data quality issues can then be communicated to the reporting entities in a Data Quality Report (DQR). The feedback loop would enable the reporting entities to improve their internal data management process that would improve the data quality over time.

12. ROADMAP AHEAD

12.1 The approach for utilization of demonetization data is to use Department's resources in a focused manner to ensure that the taxpayers comply with their primary obligations i.e. filing Income-tax Return, showing correct income in the Income-tax Return, and paying all due taxes on time.

12.2 Notices under Section 142(1) of the Income-tax Act are being issued to persons who have not filed their returns of income though they have deposited substantial cash in their bank accounts. Wide range of coordinated actions are proposed to be taken to target non-filers and untraceable cases. Indicative action points to ensure compliance by this segment may include communicating the list of such persons to the reporting entities (e.g. banks) for conducting enhanced customer due diligence and collecting additional information (KYC details and transaction details) of such persons from the reporting entities.

12.3 High risk cases will be selected for scrutiny and further investigation in a phased manner based on the risk management strategy. This selection will consider the following:

- Whether taxpayer filed the return
- Whether taxpayer mentioned the bank account in the Income-tax Return
- Whether taxpayer has broadly considered the cash deposits while computing income and paying taxes
- Whether the explanation of source of cash deposit submitted by the taxpayer is in line with the taxpayer profile.

12.4 Scrutiny and targeted enforcement actions will be used to collect additional information and ensure compliance in high-risk cases. Online system will be used to capture results of enforcement and investigation for effective monitoring. Penalties will be levied and prosecution will be initiated in appropriate cases to deter tax evaders and habitual offenders.

13. SUSTAINABLE COMPLIANCE ECOSYSTEM

13.1 Implementation of Goods and Service tax (GST) and introduction of new technologies has provided new opportunities in promoting tax compliance by businesses. These new technological options may help in reducing complexity and improving customer experience.

13.2 ITD is shifting towards a more systematic approach where tax administration engages and involves taxpayers and stakeholders in the compliance process. If tax compliance requirements are in built into the technology systems and processes used by the taxpayer for the purpose of managing the business, it will make it impossible or difficult for them to manipulate or erase information (or make such attempts easy to detect). Increased co-operation with tax service providers and industry organisations, therefore, plays an important role in promoting compliance. The three main categories of tax related services are as under:

- **Compliance:** activities focused on delivering tax returns or other reports to meet legal obligations.
- **Accounting:** bookkeeping, payroll services and preparing financial statements.
- **Advisory:** providing tax advice and representing clients in tax affairs.

There is a need to develop strong partnerships with the stakeholders to create a sustainable compliance ecosystem which can enhance the quality of compliance and tax administration in a more efficient manner.

CHAPTER

18

PMLA & Other Related Issues

A. PREVENTION OF MONEY LAUNDERING ACT, 2002

1. The term 'Money laundering' denotes a process by which the proceeds from any criminal conduct gets disguised. The money launderers hide the original ownership and control of the proceeds of crime and seek to create a subterfuge by which such proceeds appear to have been derived from a legitimate source. There is a consensus that the money laundering cycle can be broken down into three distinct stages:

1. Placement Stage
2. Layering Stage
3. Integration Stage

1.1 The Placement Stage

1.1.1 This stage represents the initial entry of the "dirty" money or "proceeds of crime" into the financial system. This is also the stage where the money launderers are most exposed and are likely to get caught easily. There are many ways to do a placement e.g. by putting money in banks in different bank accounts in small quantities; currency smuggling; asset purchase; gambling; blending of funds; etc. The placement stage may also involve active or passive complicity by the financial sector managers. To combat this and other impediments to effective money laundering investigations, many like-minded countries have met to develop, coordinate, and share model legislation, multilateral agreements, trends, intelligence and other information. The international watchdog such as the Financial Action Task Force (FATF) has evolved out of these discussions only.

1.2 The Layering Stage

1.2.1 This stage is the most complex and may also entail the international movement of the funds. The primary purpose of this stage is to introduce a disconnect between the source of the illicit money and the parking of the money in order to make it difficult to detect. This is usually done by introducing sophisticated *layering* of financial transactions to obscure the audit trail and sever the link with the original crime. This may involve converting the proceeds of crime into monetary instruments; selling assets bought

with such proceeds; moving funds from one jurisdiction to another; dividing the investments; moving the investments through various layers; exploiting loopholes or discrepancies in legislation and taking advantage of procedural delays.

1.3 The Integration Stage

1.3.1 This is the final stage where the money is returned to the criminal from what seem to be legitimate sources. Having been placed initially as cash and layered through a number of financial transactions, the criminal proceeds are integrated into the financial system and can be used for any purpose. In this stage the attempt is to reunite the money with the criminal in a manner that does not draw attention. The buying of property in benami name can be considered as an example. Obtaining capital funds or loans in business venture can be another. Making dubious export/ import transactions is also a known route.

1. STEPS TAKEN TO CONTROL MONEY LAUNDERING

2.1 In India, the initial efforts to control money laundering commenced with the Unlawful Activities Prevention Act, 1967, which was one of the first enactment to make the raising of funds for terrorism or terrorist organisations an offence. The Narcotic Drugs and Psychotropic Substances Act, 1985 also deals with proceeds of certain drug related offences. However, the processes by which criminally derived property may get 'laundered' are numerous. It is also an accepted fact that globally the crime money gets laundered on a large scale through misuse of the financial institutions. In India the Reserve Bank of India regulates the Banks and other financial institutions and the Securities Exchange Board of India regulates the capital market through its regulatory framework. However, since the workings in the financial sector involve managing, controlling and possessing money and property belonging to others, it makes it a convenient tool for the money launderers.

2.2 In India, the Prevention of Money Laundering Act, 2002 (hereinafter referred as PMLA) is the first legislation that directly deals with prevention and combating of money laundering. The law came into force on 1st July 2005. The objective of the PMLA is to have a mechanism to confiscate property derived from or involved in money laundering and to punish those who commit money laundering. The Preamble to this Act mentions that it has been enacted to implement the United Nation's Political Declaration and the Global Programme of Action on international co-operation against narcotic drugs and psychotropic substances. As part of the declaration, the Member States had been urged by the UN to prevent the use of the banking system and other financial institutions for the laundering of proceeds derived from illicit drug trafficking by making such activities criminal offences.

2.3 The PMLA is a special legislation and the offences under this Act are spelt out in Chapter II of the Act. The manner of attachment, adjudication and confiscation of property is covered in Chapter III, while the power to summon, search, seizure and arrest are detailed in Chapter V. The PMLA has specific provisions for setting up of Appellate Tribunal and appeals to High Court in Chapter VI. The provisions relating to setting up of Special Courts are given in Chapter VII and provisions relating to reciprocal International Arrangements are enumerated in Chapter IX.

2. RELEVANT PROVISIONS OF PMLA

3.1 Section 3 of the PMLA states that 'whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime including its concealment, possession,

acquisition or use and projecting or claiming it as untainted property shall be guilty of offence of money-laundering.

3.2 Section 2(u) of PMLA defines 'proceeds of crime' to mean 'any property derived or obtained, directly or indirectly, by any person as a result of criminal activity relating to a scheduled offence or the value of any such property or where such property is taken or held outside the country, then the property equivalent in value held within the country or abroad'.

3.3 Section 2(y) defines the "scheduled offence" to mean the following offences (detailed in the Schedule to PMLA) as under:

a. The offences specified under Part A of the Schedule; or

b. The offences specified under Part B of the Schedule if the total value involved in such offences is one crore rupees or more; or

c. The offences specified under Part C of the Schedule.

3. IMPLEMENTING AUTHORITIES OF PMLA

4.1 There are two distinct implementing authorities in PMLA and their scope of powers is also distinct, as under:

i. The provisions of the PMLA relating to the 'transaction reporting regime' is exclusively administered by the 'Financial Intelligence Unit'.

ii. The rest of the PMLA including the powers related to the attachment, adjudication and confiscation of the property involved in money-laundering is the domain of the officers of the Directorate of Enforcement.

4.2 The anti-money laundering measures relating to transaction reporting regime is administered by the Financial Intelligence Unit (FIU), which directly reports to the Economic Intelligence Council, which is headed by the Union Finance Minister. While the power to investigate offences under PMLA was exclusively with ED, the Government has, vide Notification dated 1st July 2005, appointed the Director, Financial Intelligence Unit, India, as the concerned authority to exclusively exercise the powers conferred under Clause (b) of sub-section (1) of Section 12 of PMLA and its related Sections. The powers of FIU range over seeking of information about certain transactions of a certain nature and value, whether attempted or executed, from the "reporting entities" i.e. a banking company, a financial institution, an intermediary or a person carrying on a designated business or profession. The Rule 3 of the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 prescribes the kind of report which need to be submitted by the reporting entities. The Rule 4 thereof mandates that the records referred to in Rule 3 shall contain all necessary information specified by the 'Regulator' to permit reconstruction of individual transaction i.e. its nature, amount, currency in which it is denominated, date of transaction and the details about the parties to the transaction. For this purpose, the reporting entities are required to verify and maintain the record of the identity of all its clients including beneficial owners as prescribed in Rule 9 &10. The reporting entities are required to furnish information relating to certain types of cash transactions; all types of suspicious transactions; specified counterfeit currency transactions, forged security or documents used; specified cross border wire transactions; sale purchase of properties; and, all transactions involving receipts by non-profit organisations of value more than rupees ten lakh, or its equivalent in foreign currency.

4.3 The Directorate of Enforcement, which is a part of the Department of Revenue, Ministry of Finance, Government of India is the main law enforcing agency for the anti-money laundering measures under PMLA. The officers of Directorate of Enforcement (ED) are specifically

authorised by the Central Government for the purposes of the investigation and prosecution of money laundering offences.

4.4 The offence of money laundering intrinsically implies that it is secondary to the commitment of several other criminal offences which are termed as 'predicate offences' under the PMLA. The proceeds of such 'predicate offences' form the subject matter of the commission of the offence of money laundering. The predicate offences are mentioned in the three parts of the Schedule to the PMLA.

4.4.1 Part A of the Schedule of PMLA covers offences under certain specified Sections of statutes like IPC, NDPS Act, Explosive Substances Act, Unlawful Activities Act, Arms Act, Wildlife Protection Act, Immoral Traffic Prevention Act, Prevention of Corruption Act, Explosives Act, Antiquities and Arts Treasures Act, SEBI Act, Customs Act, Bonded Labour System (Abolition) Act, Child Labour (Prohibition and Regulation) Act, Transplantation of Human Organ Act, Juvenile Justice (Care and Protection of Children) Act, Emigration Act, Passport Act, Foreigners Act, Copyright Act, Trademark Act, Information Technology Act, Biological Diversity Act, Protection of Land Varieties and Farmers Rights Act, Environment Protection Act, Water (Prevention and Control of Pollution) Act, Air (Prevention and Control of Pollution) Act, Suppression of Unlawful Acts against Safety of Maritime Navigation and Fixed Platform on Continental Shelf Act, and Companies Act.

4.4.2 Part B of the Schedule of PMLA includes offence under Section 132 of the Customs Act.

4.4.3 Part C of the Schedule of PMLA includes an offence which is an offence of cross border implication as specified in Part A, offences against property under Chapter XVII of IPC and the offence of wilful attempt to evade any tax, penalty or interest referred to Section 51 of the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015.

4.5 As per the scheme of PMLA, it is a prerequisite that there should be a scheduled offence which is investigated by the agencies like Police, Custom, SEBI, NCB etc under their respective statutes and appropriate reference is made by them under the relevant Sections of their statutes to the PMLA authorities. For instance, a complaint filed by the Income-tax Department under Section 51 of the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015 for the offence of wilful attempt to evade any tax, penalty or interest would make the assessee liable to be covered under the PMLA Act if the Income-tax Department intimates the Enforcement Directorate (ED). Similarly, a FIR registered by the CBI under Section 13 of the Prevention of Corruption Act for criminal misconduct by a public servant would empower the ED to initiate proceedings against the culprit under the Prevention of Money Laundering Act. Similarly, a complaint booked by SEBI under Section 12A read with Section 24 of the SEBI Act for prohibition of manipulative and deceptive devices, and insider trading would empower the ED to initiate proceedings against the culprit under the Prevention of Money Laundering Act.

4.6 To reiterate, unless and until an offence is booked by any of the Law Enforcement Agencies mentioned in the relevant Part A, Part B and Part C of the Schedule to the PMLA, the Enforcement Directorate cannot register a case suo motu under PMLA. Also, the Courts have held that when there is no specific allegation about laundering of money the offences which are mentioned in the Schedule to PMLA can be investigated by the usual investigation agencies only.

4. INVESTIGATION AND APPEAL PROCESSES UNDER PMLA

5.1 PMLA empowers certain officers of the ED to carry out investigations in cases involving offence of money laundering and also to initiate proceedings to attach the property involved in money laundering. In this work the ED authorities

can also take the assistance of officers from other services as per Section 54 of the PMLA.

5.2 PMLA also envisages setting up an Adjudicating Authority to exercise jurisdiction, power and authority to confirm the attachment or order confiscation of the attached properties.

5.3 PMLA mandates that the Tribunal as constituted under the Smugglers and Foreign Exchange Manipulators (Forfeiture of Property) Act, 1976 shall also hear appeals against the order of the Adjudicating Authority.

5.4 PMLA envisages designation of one or more Courts of sessions as 'Special Court' or Special Courts to try the offences punishable under PMLA and offences with which the accused may, under the Code of Criminal Procedure 1973, be charged at the same trial.

5.5 PMLA empowers the Central Government to enter into an agreement with Government of any country outside India for:

a. Enforcing the provisions of this Act;

b. Exchange of information for the prevention of any offence under this Act or under the corresponding law in force in that country or investigation of cases relating to any offence under this Act.

B. FINANCIAL INTELLIGENCE UNIT-INDIA

1. The Financial Intelligence Unit (FIU-IND) was established by Government of India vide Office Memorandum dated 18 November 2004. Financial Intelligence Unit-India (FIU-IND) is the central national agency for receiving, processing, analysing and disseminating information relating to suspect financial transactions. FIU-IND is also responsible for coordinating and strengthening efforts of national and international intelligence, investigation and enforcement agencies in combating money laundering, associated predicate offences and terrorist financing. It is an independent entity which reports the Economic Intelligence Council headed by the Union Finance Minister. Administratively, the unit is under the control of Department of Revenue, Ministry of Finance.

2. The Core functions of FIU-IND are as under:

a. **Intelligence Management:** These function relate to maintaining a national database of Cash Transaction Reports (CTRs), Suspicious Transaction Reports (STRs), Counterfeit Currency Reports (CCRs), NPO Sector Transaction Report (NTR) and Cross Border Wire Transfer Report (CBTR) received from the reporting entities under the provisions of the PMLA. It includes conducting operational and strategic analysis of the statutory reports received; screening and processing requests for information from domestic law enforcement & intelligence agencies and from foreign FIUs; and, disseminating actionable intelligence to domestic law enforcement & intelligence agencies and to foreign FIUs.

b. **Strategic Management:** These functions relate to reviewing operational and regulatory issues and suggesting policy changes to counter money-laundering, associated predicate offences and terrorist financing. They include steps like promoting awareness on issues relating to money laundering and terrorist financing; building capacities in the financial sector for effective identification and reporting of prescribed transactions.

3. FIU-IND administers certain provisions of the Prevention of Money Laundering Act, 2002 (PMLA) which relate to the reporting of specified transactions by the reporting entities. The reporting entity is obligated to ensure client due diligence, maintenance of record of specified transactions for the prescribed period and

furnishing report of the prescribed transactions to FIU-IND. As per Section 2(wa) of PMLA a "reporting entity" means a banking company, financial institution, intermediary or a person carrying on a designated business or profession. The reporting entities are required to furnish information relating to certain cash transactions; all types of suspicious transactions; specified counterfeit currency transactions, forged security or documents used; specified cross border wire transactions; sale purchase of properties; and, all transactions involving receipts by non-profit organisations of value of more than rupees ten lakh, or its equivalent in foreign currency.

4. As per the 'Prevention of Money Laundering (Maintenance of Records of the Nature and Value of Transactions, the Procedure and Manner of Maintaining and Time of Furnishing Information and Verification and Maintenance of Records of the Identity of the Clients of the Banking Companies, Financial Institutions and Intermediaries) Rules, 2005' the word 'transaction' includes deposit, withdrawal, exchange or transfer of funds in whatever currency, whether in cash or by cheque, payment order or other instruments or by electronic or other non-physical means. As per Rule 2(g), a suspicious transaction means a transaction whether or not made in cash which, to a person acting in good faith:

a. Gives rise to a reasonable ground of suspicion that it may involve the proceeds of crime; or

b. Appears to be made in circumstances of unusual or unjustified complexity; or

c. Appears to have no economic rationale or bona fide purpose.

5. FIU-IND analyses these reports and disseminates the information to appropriate enforcement/intelligence agencies. The recipients of such information are the Ministry of Home Affairs, Research & Analysis Wing, Intelligence Bureau, National Security Council Secretariat, Central Board of Direct Taxes, Central Board of Excise & Customs, Directorate of Enforcement, Narcotics Control Bureau, Central Bureau of Investigation, Reserve Bank of India, Securities and Exchange Board of India and Insurance Regulatory Development Authority.

6. The FIU-IND is also a member of the Egmont Group, which is a united body of 159 Financial Intelligence Units (FIUs) spread all over the globe. It provides a platform for the secure exchange of expertise and financial intelligence to combat money laundering and terrorist financing. This is especially relevant as FIUs are uniquely positioned to cooperate and support national and international efforts to counter terrorist financing and are the trusted gateway for sharing financial information domestically and internationally in accordance with global Anti Money Laundering and Counter Financing of Terrorism standards.

C. DIRECTORATE OF ENFORCEMENT

1. The Directorate of Enforcement (ED) was established in the year 1956 with its Headquarters at New Delhi. The ED has one Director, two Special Directors, one Special Director and it has 10 Zonal offices, each of which is headed by a Deputy Director. It has 11 Sub-Zonal Offices each of which is headed by an Assistant Director. The Zonal offices are at Mumbai, Delhi, Chennai, Kolkata, Chandigarh, Lucknow, Cochin, Ahmedabad, Bangalore & Hyderabad. The Sub-Zonal offices are at Jaipur, Jalandhar, Srinagar, Varanasi, Guwahati, Calicut, Indore, Nagpur, Patna, Bhubaneshwar & Madurai.

2. Functions: The main functions of the Directorate are as under:

a. To enforce Foreign Exchange Management Act 1999; Prevention of Money Laundering Act, 2002; and the Fugitive Economic Offenders Act, 2018

b. To collect, develop and disseminate intelligence relating to violation of FEMA.

The intelligence inputs are received from various sources such as various Central and State Intelligence agencies, complaints, informers etc.

c. To investigate offences under the concerned statutes e.g. cases of foreign exchange racketeering, non-realization of export proceeds, non-repatriation of foreign exchange, "hawala" and other forms of violations under FEMA, 1999. To undertake survey, search, seizure, arrest, prosecution action etc. against offenders under PMLA. To provide and seek mutual legal assistance to/ from contracting states in respect of attachment/ confiscation of proceeds of crime as well as in respect of transfer of accused persons under PMLA. To attach and confiscate the property of a person on being declared as a Fugitive Economic Offender.

d. To conduct searches on suspected persons, conveyances and premises and seize incriminating materials (including Indian and foreign currencies involved)

e. To adjudicate cases of penalties levied for violation of Foreign Exchange Management Act and to confiscate the amounts involved in the impugned violation.

f. To realize the penalties imposed in departmental adjudication;

g. To attach and confiscate properties involved in the act of money laundering;

h. To arrest the person suspected to be involved in the act of money laundering;

i. To prosecute the person involved in the act of money laundering.

2.1 In addition to the above functions relating to the Foreign Exchange Management Act, the ED also processes and recommends cases for detention of habitual offender under the Conservation of Foreign Exchange and Prevention of Smuggling Activities Act,1974 (COFEPOSA), which inter alia provides for detention of a person with an intention of preventing him from acting in a manner prejudicial to the conservation and augmentation of foreign exchange.

3. The ED is under the administrative control of Department of Revenue for operational purposes; however, the policy aspects of the FEMA, its legislation and its amendments are within the purview of the Department of Economic Affairs. Further the policy issues pertaining to PMLA are the responsibility of the Department of Revenue. Before FEMA became effective (w.e.f.1 June 2000), the ED was required to enforce the erstwhile Foreign Exchange Regulation Act, 1947 and the Foreign Exchange Regulation Act, 1973 (both laws are repealed). They also handle pending matters relating to the adjudication, appeals and prosecution cases under the erstwhile FERA, 1973

D. THE FUGITIVE ECONOMIC OFFENDERS ACT, 2018 (FEOA)

1. This law has been enacted by the Parliament on 31st July 2018 and it is deemed to have come into force w.e.f. 21st April 2018. This Act seeks to provide for measures to deter fugitive economic offender from evading the process of law in India by staying outside the jurisdiction of Indian courts. As per Section 2(f) of the FEOA a "fugitive economic offender" means any individual against whom a warrant for arrest in relation to a Scheduled Offence has been issued by any Court in India, who:

i. Has left India so as to avoid criminal prosecution; or

ii. Being abroad, refuses to return to India to face criminal prosecution.

The Section 2(m) of the FEOA defines "Scheduled Offence" to mean an offence specified in the Schedule, if the total value involved in such offence or offences is one

hundred crore rupees or more. The Schedule to the Act lists the various offences under various statutes which are covered under the term 'scheduled offences'.

The FEOA is to be administered by the officers of Enforcement Directorate. They can file an application before the Special Courts to have a person declared as a fugitive economic offender. The officers can, with the permission of the Special Court, attach any property of the fugitive economic offender. There are provisions for provisionally attaching the properties also. The officers are empowered to conduct surveys and also to conduct search & seize operations. The Special Courts can confiscate, both local and overseas assets of the alleged offenders who do not wish to return to India to stand trial even after arrest warrants are issued against them. These assets can be proceeds of crime or benami. This law shall help the authorities to confiscate properties of such fugitives even before they are convicted. It seeks to confiscate properties and assets of economic offenders who evade prosecution by remaining outside the jurisdiction of Indian Courts. The economic offences, with a value of more than Rs. 100 crores, which are listed in the schedule of the Fugitive Economic Offenders Bill, come under the purview of this law.

CHAPTER 19

Exemption: Basis of Rejection of 12A Registration

1. The power to grant registration *u/s* 12AA of the Act lies with the respective Commissioners of Income-tax (Exemption) and they only have to consider rejection of registration if the same is warranted in the given facts of the case. However, the matter of cancellation of registration *u/s* 12AA may also have to be dealt with by the Pr. CsIT (Central) charges in respect of cases centralized with them. For registration *u/s* 12AA of the Act, the applicant has to apply before the Commissioner having jurisdiction over its registered office in the prescribed Form 10A. After hearing the assessee and causing inquiry (in cases that is deemed fit to cause inquiry) the Commissioner may either grant the registration *u/s* 12AA or reject the application within six months from the end of the month in which the application in Form 10A was submitted.

Application for registration of charitable or religious trusts under Section 12A of the Act:

2. The CBDT has notified Income-tax (1st Amendment) Rules, 2018, to amend Rule 17A of the Income-tax Rules relating to the application procedure for registration of charitable or religious trusts under Section 12A of the Act. Also, Form 10A prescribed for making an application for granting registration has been amended and the same is to be submitted digitally by the person authorised to submit ITR.

As per the CBDT Notification No.10/ 2018 dated 19.02.2018 and Amended Rule 17A, to obtain Registration under Section 12A of the Act, the Application has to be made by the charitable or religious trusts electronically online in Form 10A to the Commissioner of Income-tax.

2.1 As per the revised Rule, the application under Clause (aa) or Clause (ab) of sub-section (1) of Section 12A for registration of a charitable or religious trust or institution shall be made in Form No. 10A and accompanied by the following documents:

a. Where the trust is created, or the institution is established, under an instrument, self-certified copy of the instrument creating the trust or establishing the institution;

b. Where the trust is created, or the institution is established, otherwise than under an

instrument, self-certified copy of the document evidencing the creation of the trust, or establishment of the institution;

c. Self-certified copy of registration with Registrar of Companies or Registrar of Firms and Societies or Registrar of Public Trusts etc.

d. Self-certified copy of the documents evidencing adoption or modification of the objects, if any;

e. Where the trust or institution has been in existence during any year or years prior to the financial year in which the application for registration is made, self certified copies of the annual accounts of the trust or institution relating to such prior year or years (not being more than three years immediately preceding the year in which the said application is made) for which such accounts have been made up;

f. Note on the activities of the trust or institution;

g. Self-certified copy of existing order granting registration under Section 12A or Section 12AA, as the case may be; and

h. Self-certified copy of order of rejection, if any, of application for grant of registration under Section 12A or Section 12AA as the case may be.

2.2 Form No. 10A shall be furnished electronically,

i. Under digital signature, if the return of income is required to be furnished under digital signature;

ii. Through electronic verification code in a case not covered under Clause (i).

2.3 Form No. 10A shall be verified by the person who is authorised to verify the return of income under Section 140 of the Act, as applicable to the assessee.

2.4 The Principal Director General of Income-tax (Systems) or the Director General of Income-tax (Systems), as the case may be, shall specify the data structure, standards and procedure of furnishing and verification of Form No. 10A and be responsible for formulating and implementing appropriate security, archival and retrieval policies in relation to the said form so furnished.

2.5 It is important to note that Finance Act, 2017 has inserted Clause (ab) after Clause (aa) of sub-section (1) of Section 12A, which provides that;

where a trust or an institution has been granted registration and subsequently it has adopted or undertaken modifications of the objects which do not conform to the conditions of registration, it shall be required to obtain fresh registration by making an application within a period of thirty days from the date of such adoption or modifications of the objects in the prescribed form and manner.

Therefore, a fresh registration of Trust is necessary where the trust or the institution had been granted registration and subsequently it has adopted or undertaken modifications of the objects which do not conform to the conditions of registration.

3. PROCEDURE FOR GRANTING/ REFUSING 12A REGISTRATION

3.1 Once the application is submitted online in the prescribed Form 10A, the Commissioner may request the applicant to submit additional information or documents, as he/ she deems fit. The request for additional information or documents would be to satisfy the Commissioner as to the genuineness of the activities of the Trust or Institution. If the Commissioner is satisfied with the application, then he/ she will pass an order in writing registering the Trust or Institution under 12A of the Act. However, in case the Commissioner is not satisfied with the application, then he/ she can also pass an order in writing refusing to register the Trust or

Institution. Order granting or refusing registration shall be passed before the expiry of six months from the end of month in which application was received under Section 12A.

3.2 Before granting registration, the Commissioner has to be satisfied about the genuineness of the activities of the trust and compliance of other legal and procedural requirements. In case the Commissioner is not satisfied with the application, he/ she has to pass an order in writing rejecting the request to grant registration of the Trust or Institution. Some of the reasons and circumstances which could be the basis for considering a trust for rejection of registration are discussed as below. The rejection of application of registration *u/s* 12A may be because of one or more of such reasons:

3. Non-compliance to the hearing notice by the applicant.
4. The address mentioned by the applicant in the Form is found to be non-existing.
5. The stated objectives of the trust or the activities carried out are not covered *u/s* 2(15) of the Income-tax Act, 1961.
6. The instrument of creation is either non-existing or not produced in original as mandated vide Rule 17A.
7. Any of the stated objectives is in violation to any provision of Section 11 or 13 of the Act.
8. There is no activity carried on by the trust since its inception.
9. The activity carried on by the trust is not genuine or not covered in the stated objectives.
10. The tax due for earlier years i.e. before the year in which the application has been made, has not been paid by the applicant.
11. Inconsistencies in the Object Clauses.
12. Inconsistencies in Revocation Clause of Trust deed.
13. Business Purpose in Objects.
14. Details of donors have not been provided to the Commissioner.

4. The issues mentioned at sl. 1 to 4 above do not need any detailed discussion as those are fundamental conditions relating to the very existence and functionality of the Trust. However, the issues mentioned at point 5 to 12 need some deliberation.

5. STATED OBJECTIVE IS IN VIOLATION TO ANY PROVISION OF SECTION 11 OR 13 OF THE ACT

Once the registration *u/s* 12AA is granted on the stated objectives, it becomes very difficult for the assessing officer to take any adverse view as long as the assessee abides by those objectives. Therefore, if any of the stated objective(s) is in violation to any of the provisions as laid down in Section 11 or 13 of the Act, then the applicant should be given an opportunity to amend such objective(s). In case the applicant refuses to do so then there could be a case for cancelling the registration *u/s* 12AA of the Act.

6. NO ACTIVITY BY THE TRUST SINCE ITS INCEPTION

At the outset it is pertinent to have a look at the Section 12AA which was inserted by the Finance (No 2) Act, 1996, with effect from April 1, 1997. The Section reads as under:

i. The Chief Commissioner or Commissioner, on receipt of an application for registration of a trust or institution made under Clause (a) of Section 12A, shall

a. call for such documents or information from the trust or institution as he thinks necessary in order to satisfy himself about the genuineness of activities of the trust or institution and may also make such inquiries as he may deem necessary in this behalf; and

b. after satisfying himself about the objects of the trust or institution and the genuineness of its activities, he

i. shall pass an order in writing registering the trust or institution;

ii. shall, if he is not so satisfied, pass an order in writing refusing to register the trust or institution, and a copy of such order shall be sent to the applicant". [Emphasis added]

6.2 The purpose for inclusion of the above provision was to provide for a standard procedure to be followed for grant of registration to a trust or institution. It is evident from the plain reading of the Act that Section 12AA(1) clearly stipulates that the Commissioner *shall* satisfy himself about the objects *and* the genuineness of its activities. Therefore, satisfaction of the Commissioner is must about the genuineness of the activities, *inter alia,* before granting of registration. Therefore, for a trust or institution it is mandatory to do charitable activities that will stand the test of inspection by the Commissioner before the registration is granted. In absence of any worthwhile activity by the trust or institution the Commissioner does not have a chance to satisfy himself about the genuineness of any activity.

6.3 It is also to be noted that prior to insertion of Section 12AA, there was no provision in the Act that put any precondition for granting of registration *u/s* 12A. The *mischief rule,* when applied to this situation lead to the inescapable conclusion that a trust or institution must do charitable activity before it becomes eligible to get registration *u/s* 12AA of the Act.

6.4 An identical view has been expressed by Hon'ble Kerala High Court in the case of Self *Employers Service Society vs. Commissioner of Income-tax*, 247 ITR 018 [2001]. In this case both the single bench and on appeal filed by the assessee, the division bench of the Hon'ble High Court decided the issue in favour of the revenue. Therefore, in a case where no activity has been carried out by a trust since its inception, it may not be a case to grant registration *u/s* 12AA of the Act.

7. THE ACTIVITIES CARRIED OUT BY THE TRUST, IS NOT GENUINE OR NOT COVERED IN THE STATED OBJECTIVES

The trust can only do activities under the aegis of the stated objectives. Hence, registration could be denied in a case where any activity is done which may be charitable is nature but the same is not in tune with its stated objectives. Further to the above, registration could also be denied in a case where any activity is carried out which is found to be not charitable in nature *u/s* 2(15) of the Act. In a case where it is found, either from the documents or through inquiry, that the activity of the trust is not genuine, i.e the trust is found to be indulging into an activity such as booking of bogus or inflated expenses, violation of some other law etc., granting of registration *u/s* 12AA has to be denied.

8. THE TAX DUE IN EARLIER YEARS BEFORE THE YEAR IN WHICH THE APPLICATION HAS BEEN MADE HAS NOT BEEN PAID BY THE APPLICANT

The registration *u/s* 12AA becomes effective from the 1st of April of the year in which the application in Form 10A is filed before the Commissioner. In many cases it is seen that despite having surplus of income over expenditure, applicants do not file Income-tax Returns or pay tax that was due in respect of the years preceding the year in which the application is made. As per Section 139(1)(b) of the Income-tax Act, 1961, it was obligatory on the part of the applicant to file Income-tax Returns, as the income exceeded the maximum amount which was not chargeable to

Income-tax. Hence, it is to be decided whether the applicant trust is still eligible for grant of registration *u/s* 12AA even if it does not pay tax on surplus of income (in respect of the years preceding the year in which the application is made).

8.2 The procedure of registration envisaged in Section 12AA prescribes;

(1) satisfaction of the Commissioner about the objects of the trust or institution, and

(2) genuineness of the activities.

8.3 Similarly the procedure for cancellation of registration *u/s* 12AA(3) also empowers the Commissioner to cancel the registration under following two circumstances;

1. When the activities of the Trust are not 'Genuine' and
2. When the activities are not being carried out in accordance with the objectives of the Trust or institution;

8.4 Therefore, the procedure for grant of registration and cancellation thereof mandates that *not only the object of the trust should be charitable but its activities should also be genuine.* This clearly denotes that an applicant whose objects are otherwise charitable in nature will not *ipso facto* be eligible for registration *u/s* 12AA unless its activities are genuine also. The word 'Genuineness' has not been defined in the Income-tax Act and, therefore, as per rule of interpretation of statutes, literal meaning of the word 'genuineness' has to be taken. According to Oxford Dictionary, the meaning of Genuineness is:

> *"The quality of being* sincere and honest *and able to be trusted"*

8.5 Non-payment of undisputed tax cannot qualify as genuine because it is not an honest conduct. Hence, let us proceed to examine the consequences of grant of registration in this scenario. Section 12A, which precedes Section 12AA, defines the conditions for applicability of Section 11 and 12. The grant of registration *u/s* 12AA brings the assesse in the ambit of Sections 11 and 12. The first proviso to Sub-section 2 of Section 12A reads as under:

> *"Provided that where registration has been granted to the trust or institution under Section 12AA, then the provisions of Section 11 and 12 shall apply in respect of any income derived from property held under trust of any assessment year preceding the aforesaid assessment year, for which assessment proceedings are pending before the Assessing Officer as on the date of such registration and the objects and activities of such trust or institution remain the same for such preceding assessment year"*

8.6 The first proviso states that the provision of Section 11 and 12 shall apply to any assessment which is pending on the date of grant of registration. It does not state that the provision of Section 11 and 12 will be applicable to all income right from the inception of the trust whose objects are charitable in nature. The benefit of grant of registration *u/s* 12AA is, therefore, applicable only in case of pending assessments.

8.7 The 2nd proviso further states that, *'no action under Section 147 shall be taken by the Assessing Officer in case of such trust or institution for any assessment year preceding the aforesaid assessment year only for non-registration of such trust or institution for the said assessment year'.*

8.8 Thus, if registration *u/s* 12AA is granted in this scenario, the AO will be precluded from taking any action *u/s* 147 of the Act. Therefore, in such cases, registration has to be denied to bring the admitted income within the purview

of taxation. Any interpretation of the provisions of the Act which takes away the right to collect legitimate tax would be inconsistent with the Act itself.

8.9 Since, grant of registration *u/s* 12AA takes away the right of the AO to bring to tax any income by issuing notice *u/s* 147, the only logical recourse for the Commissioner in such circumstances is to refuse registration *u/s* 12AA so that admitted tax is recovered as per the provisions of law. However, if the provisos are interpreted in a manner so as to mean that after the grant of registration, the income of the trust or institution becomes exempt or eligible for the benefit of Section 11 and 12 since its inception and not only in respect of pending assessment proceedings, then the registration *u/s* 12AA becomes redundant. A hypothetical situation will make the understanding of the issue better.

Suppose there are two Charitable trusts—A and B. They have same credentials like date of creation, objectives, turnover etc. Let us further assume that both the trusts have surplus at the end of the F.Y.s regularly. Trust A pays tax regularly on its Surplus of income. Trust B does not pay tax on its Surplus of income. Let us presume in F.Y. 2017–18, both the Trusts get registration *u/s* 12AA. In that case, trust B does not need to pay tax for the earlier years' surplus amount any more. But the Trust A will not receive refund of the taxes paid in earlier years. Here even though both the trusts worked in the same field and did same kind of charitable activity, Trust A will be at a disadvantageous position even though it abided by the provisions of the Income-tax Act and is genuine. Needles to say, any interpretation which denies premium on compliance of law has to be shunned.

Therefore, it is seen from the above example that if the proviso to Section 12A is interpreted in a way to mean that the income of the Trust or institution becomes exempt or eligible for the benefit of Section 11 and 12 since its inception and not in respect of the pending assessment proceedings only, then the person violating the Act will get more benefit than the one who complied with it. This can *never* be the intention of the statute.

8.10 In view of the above, the Commissioner has to consider non-payment of taxes on admitted surplus as non-genuine and consequently deny registration as per the statute. As stated earlier, the law only provides that the benefits of Section 11 and 12 shall be available to the applicant in cases of pending assessments. Registration *u/s* 12AA in such cases will be a *carte blanche* for the applicant who did not pay the taxes, to flout the law with impunity. Therefore, non-payment of due tax could be a valid reason for denial of grant of registration *u/s* 12AA.

9. CORPUS DONATION BEFORE REGISTRATION

This issue will come into consideration only where denial of exemption *u/s* 11(1)(d) results in taxable income. It is seen that many a times tax liability arises when the applicant is denied the benefit of Section 11(1)(d). In many cases the trusts claim the exemption *u/s* 11(1)(d) in the years before the year in which they applied for grant of registration claiming that they have received corpus donation. It is imperative to consider such claim objectively. At the outset the relevant Sections of the Income-tax Act, 1961 need to be perused. Till A.Y. 1988–89 Section 2(24)(iia) stood as under:

2. In this Act, unless the context otherwise requires: (24) "income" includes:

> *(iia) voluntary contributions received by a trust created wholly or partly for charitable or religious purposes or by an institution established wholly or partly for such purposes, not being contributions made with a specific direction that they shall form part of the corpus of the trust or institution.*

Explanation: For the purposes of this sub-Clause, "trust includes any other legal obligation.

It is also to be noted that till A.Y. 1988–89 the Section 11(1)(d) was not there in place. From A.Y. 1989–90 i.e. with effect from 01-04-1989, the Section 2(24)(iia) was amended as under:

2. In this Act, unless the context otherwise requires:

(24) "income" includes:

(iia) voluntary contributions received by a trust created wholly or partly for charitable or religious purposes or by an institution established wholly or partly for such purposes or by an association or institution referred to in Clause (21) or Clause (23), or by a fund or trust or institution referred to in sub-Clause (iv) or sub-Clause (v) of Clause (23C,), of Section 10.

Explanation: For the purposes of this sub-clause, "trust includes any other legal obligation.

The last amendment in this Section was made in 2007 with effect from A.Y. 2008–09. Since then the Section lays down the following:

2. In this Act, unless the context otherwise requires:

(24) "income" includes:

(iia) voluntary contributions received by a trust created wholly or partly for charitable or religious purposes or by an institution established wholly or partly for such purposes or by an association or institution referred to in Clause (21) or Clause (23), or by a fund or trust or institution referred to in sub-Clause (iv) or sub-Clause (v) or by any university or other educational institution referred to in sub-Clause (iiiad) or sub-Clause (vi) or by any hospital or other institution referred to in sub-Clause (iiiae) or sub-Clause (via)] of Clause (23C) of Section 10.

Explanation: For the purposes of this sub-clause, "trust includes any other legal obligation.

It is seen from the above that he words *"not being contributions made with a specific direction that they shall form part of the corpus of the trust or institution"* has been removed from the Section w.e.f. 01-04-1989. When the mischief rule is applied it becomes evident that before 01-04-1989 the *corpus donation* was not an income at all. However, from 01-04-1989 such corpus donation is income just like any other voluntary contribution.

From this very period i.e. A.Y. 1989–90 with effect from 01-04-1989 Section 11(1)(d) was introduced. This Section says:

11 (1) Subject to the provisions of Sections 60 to 63, the following income shall not be included in the total income of the previous year of the person in receipt of the income

(d) income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution.

9.2 So it is evident that from 01-04-1989, corpus donation will be exempt only under Section 11(1)(d) and an assessee can claim benefit *u/s* 11 only when such assessee is registered *u/s* 12A or 12AA. This assertion is not only backed by the statute but also by the decision of Hon'ble Supreme Court in the case of *CIT vs. UP Forest Corporation*, 230 ITR 945 (SC) [1998] and decisions of various other Hon'ble High Courts like:

a. New Life in *Christ Evangelsit Association vs. CIT* reported in 246 ITR 532 (Madras) [2001]

b. *CIT vs. Red Rose School* reported in 212 CTR (All) *394*

c. *M. Visvesvaraya Industrial Research & Development Centre vs. ITAT* reported *in* 251 ITR 852 (Mumbai) [2001]

d. *CIT vs. Otacamund Gymkhana Club* reported in 110 ITR 392 (Madras) [1977]

e. *Gouri Shankar Deity vs. Union of India* 145 ITR 67 *(MP) [1984]*

Before the period of grant of registration, all voluntary contributions (including the ones with specific direction that they shall form part of the corpus) is income of a charitable, religious or charitable cum religious trust. Hence, after taking *corpus donation* as income if the applicant becomes liable to pay tax then the registration *u/s* 12AA cannot be granted unless the tax is paid.

10. INCONSISTENCIES IN THE OBJECT CLAUSES

On the basis of any objects of the trust deed, if the Commissioner has reasons to believe that the Beneficiaries of the Trust activities will be based on the particular caste, creed or sex, he may refuse the registration.

11. INCONSISTENCIES IN REVOCATION CLAUSE OF TRUST DEED

As per Bombay Public Trust Act 1950 the trusts are always irrevocable. Generally the trust can't be revoked. However, if the circumstances arise than trust can be revoked by passing an unanimous resolution by all the trustees to that effect and with the prior approval of the Charity Commissioner and in that scenario none of the assets will go in hands of any of the trustees/ settler or to the members of the trust. On the contrary it will be handed over to the trust having same objects. In many cases the trusts do not have revocation Clause altogether and even if they have the resolution Clause then it is not proper to the effect that all these formalities in revocation Clause of the trust deed are not clearly mentioned. In such cases, Commissioner may refuse the registration.

12. BUSINESS PURPOSE IN OBJECTS

If the commissioner is of the view that the objects of the trusts are not the charitable purposes as defined *u/s* 2(15) and on the contrary the activities are such which is in the nature of trade and commerce, the Commissioner may reject such application for granting registration.

13. DETAILS OF DONORS NOT PROVIDED

It was held in the case of Commissioner of Income-tax, *Rohtak vs. Savior Charitable Trust* [2013] 35 taxmann.com 295 (Punjab & Haryana) that failure to furnish complete details regarding donors would result in denial of registration as a charitable trust. The list of donors showed that the only names are mentioned without any address. The lack of information in respect of parentage, age, address or PAN numbers in the list of donors are the good reasons for declining the registration of the assessee as a charitable trust. The list of such donors is sufficient to infer that about the genuineness of the activities of the trust.

14. CANCELATION OF REGISTRATION GRANTED UNDER SECTION 12A OF THE ACT

The power of cancellation of registration is inherent and flows from the authority of granting registration. However, judicial rulings in some cases have held that the Commissioner did not had the power to cancel the registration which was obtained earlier by any trust or institution under provisions of Section 12A of the Act as it was not specifically mentioned in Section 12AA of the Act. Hence, to fetch further clarity on the issue, Finance Act, 2010 amended Section 12AA(3) and explicitly empowered the Commissioner to withdraw exemption in the case of registration *u/s* 12A as well w.e.f. 01.06.2010. The relevant provision of Section 12AA(3) is as below:

(3) Where a trust or an institution has been granted registration under Clause (*b*) of sub-section (1) or has obtained registration at any time under Section 12A as it stood before its amendment by the Finance (No. 2) Act, 1996 (33 of 1996) and subsequently the Principal Commissioner or Commissioner is satisfied that the activities of such trust or institution are not genuine or are not being carried out in accordance with the objects of the trust or institution, as the case may be, he shall pass an order in writing cancelling the registration of such trust or institution:

Provided that no order under this sub-section shall be passed unless such trust or institution has been given a reasonable opportunity of being heard.]

14.2 In the case of *DIT (E) vs. Mool Chand Khairati Ram Trust*, 243 CTR (Del) 245, the question before the Hon'ble High Court was whether the DIT (E) was justified in cancelling the registration under Section 12A (3) w.e.f. 2002–03 vide his order dated 30th June, 2009 when the power to cancel the registration obtained under Section 12A came to be incorporated by way of amendment introduced in Section 12AA(3) by Finance Act, 2010 w.e.f. 1.6.2010. The *ratio decidendi* of the judgment of Hon'ble Delhi High Court in this case is that now w.e.f. 1.6.2010, the power vests with the CIT even to cancel registration granted under any of the Clauses of Sub Section (1) of Section 12A.

This view also finds support from the decision of Hon'ble Bombay High Court in the case of Sinhagad Technical Education Society [2012] 19 taxmann.com 136 (Bom.) wherein the Hon'ble High Court dismissed assessee's writ petition against the fresh show-cause notice issued by the CIT dated 11 March 2011 proposing to invoke the powers under the amended provisions of Section 12AA(3) for cancellation of the registration w.e.f. A.Y. 1999–2000. It was held by the Hon'ble High Court that as a result of the amendment, which has been brought about by the Finance Act of 2010, Sub-section (3) of Section 12AA has been amended specifically to empower the Commissioner to cancel a registration obtained under Section 12A as it stood prior to its amendment by the Finance (No.2) Act, 1996. Sub-section (3) was inserted into the provisions of Section 12AA by the Finance (No.2) Act, 2004 with effect from 1 October 2004. As it originally stood, under sub-section (3), a power to cancel registration was conferred upon the Commissioner where a trust or an institution had been granted registration under Clause (b) of sub-section (1) of Section 12AA. The Commissioner, after satisfying himself that the objects of the trust or an institution are not genuine or are not being carried out in accordance with the objects of the trust or institution, as the case may be, was vested with the power to pass an order in writing cancelling the registration of such trust or institution. By the Finance Act of 2010, sub-section (3) was amended so as to empower the Commissioner to cancel the registration of a trust or an institution which has obtained registration at any time under Section 12A (as it stood before its amendment by the Finance (No.2) Act, 1996). As a result of the amendment, a regulatory framework is now sought to be put in place so as to cover also a trust or an institution which has obtained registration under Section 12A as it stood prior to its amendment in 1996. Every statutory provision which operates in respect of a trust, which has already been registered in the past does not have a retrospective character. A law which operates with respect to an event which has occurred in the past is not necessarily retrospective. A provision is retrospective when it takes away a right which has vested or accrued in the past. The effect of the provision is to empower the Commissioner to cancel the registration of a trust where he is satisfied that the activities of the trust are not genuine or are not being carried out in accordance with the objects of the trust or institution. This cannot by any stretch of imagination, be regarded as a retrospective alteration of the law.

14.3. However, on perusal of the provision of Section 12AA (3), it is apparent that it only empowers the CIT to withdraw exemption when the activities of the trust are not genuine or are not being carried out in accordance with the objects of the trust or institution. The word 'genuine' has not been defined in the Income-tax Act and, therefore, as per rule of interpretation of statutes, literal meaning of the word has to be taken. As per Dictionary meanings the word 'Genuine' is "truly what something is said to be; authentic", "real; and exactly what it appears to be", having "Sincere", "honest" and "truthful" as it's synonyms. Further, since all these Sections i.e. Section 11, 12, 13, 12A and 12AA deal with exemption for 'charitable purpose' only, the word 'genuine' can only be understood in the background or in connection in which it is used, i.e. the objects of the trust so as to arrive at a correct understanding of the material facts. Otherwise, a profit making private company which may also be involved in 'genuine' activities and which also may be true to its 'objects' may also qualify to be a 'charitable organisation'...!

In this regard, it would be pertinent to refer to the decision of Hon'ble Kerala High Court in the case of *Norka Roots vs. Commissioner of Income-tax* [2018] 89 taxmann.com 181 (Kerala). In this case, the assessee-trust was formed with object of promotion of interests of non-resident Keralites. It filed application seeking registration under Section 12AA.The Commissioner found that under cover of promoting interests of non-resident Keralites, assessee was in receipt of income from certification, bank interest, project identity card but, there was no expenditure for charitable purpose made from such income generated. It was also noticed that charitable activities carried out by assessee merely related to expending fund provided by Government, that too, not to its full extent. Accordingly, it was concluded that though technically, objects of assessee came within ambit of advancement of objects, of general public utility, as described in Section 2(15) as it existed prior to assessment year 2009–10, it had not carried out any such charitable activity. Commissioner thus rejected assessee's application for registration. Tribunal and subsequently Hon'ble High Court upheld order passed by the Commissioner.

14.4 Hence, the Commissioner is required to carefully examine all relevant facts before him primarily as to the genuineness of the activities of the trust so as to come to a conclusion as to whether registration of a trust is required to be cancelled which should invariably be on account of either the activities of the trust are found to be not genuine or are found to be not being carried out in accordance with the objects of the trust or institution.

15. In this regard it is also relevant to refer to CBDT's Circular No. 21/ 2016 dated 27.05.2016 in which it has been clarified that it shall not be mandatory to cancel the registration already granted *u/s* 11 to a charitable institution merely on the ground that the cut-off specified in the proviso to Section 2(15) of the Act is exceeded in a particular year without there being any change in the nature of activities of the institution. If in any particular year, the specified cut-off is exceeded, the tax exemption would be denied to the institution in that year and cancellation of registration would not be mandatory unless such cancellation becomes necessary on the ground(s) prescribed under the Act. The CBDT has also advised field authorities that in view of the adverse consequences of Xii-B, the registration of a charitable institution granted *u/s* 12AA should not be cancelled just because the proviso to Section 2(15) comes into play. The process for cancellation of registration is to be initiated strictly in accordance with Section 12AA (3) and 12AA(4) after carefully examining the applicability of these provisions.

CHAPTER

20

Verification of Information by I&CI

1. BRIEF SUMMARY

1.1 The Income-tax Department had setup a Central Information Branch (CIB) for strengthening the tax data-base in 1975. Initially, CIB was part of the Investigation Wing. In 2007 it was brought under a newly created Directorate of Income-tax (Intelligence). As further economic reforms led to India's increased integration with the rest of the world's economy, it also led to an easier cross-border flow of workforce and capital. These developments gave rise to more complex tax avoidance and tax evasion incidents. Simultaneously, there was an increased awareness to put pressure on financial institutions, tax havens and countries to conform to new norms of 'exchange of information' and transparency in the financial sector. In this scenario, the Government of India adopted a five-fold strategy to tackle the menace of illicit funds. The strategy comprises:

i. Joining global crusade against 'black money';

ii. Creating an appropriate legislative framework;

iii. Setting up institutions for dealing with Illicit Funds;

iv. Developing systems for implementation; and

v. Imparting skills to the manpower for effective action.

1.2 In the above context and taking further the strategy of setting up institutions for dealing with illicit funds, the Government vide Notification No. 29/ 2011, dated 30th May, 2011, had setup the Directorate of Income-tax (Criminal Investigation) and the activities of the erstwhile CIB were also brought under its ambit. This Directorate is required to perform functions in respect of criminal matters having any financial implication punishable as an offence under any direct tax law, including inter-alia Chapter XXII of the Income-tax Act, 1961 and Chapter VII of the Wealth Tax Act, 1957. As per the Notification, the Directorate, in discharge of its responsibilities, is required to perform the following functions:

a. To seek and collect information about persons and transactions suspected to be involved in criminal activities having cross-border, inter-state or international ramifications, that pose a threat to national

security and are punishable under the direct tax laws;

b. To investigate the source and use of funds involved in such criminal activities;

c. To cause issuance of a show cause notice for offences committed under any direct tax law;

d. To file prosecution complaint in the competent court under any direct tax law relating to a criminal activity;

e. To hire the services of special prosecutors and other experts for pursuing a prosecution complaint filed in any court of competent jurisdiction;

f. To execute appropriate witness protection programmes for effective prosecution of criminal offences under the direct tax laws, i.e. to protect and rehabilitate witnesses who support the state in prosecution of such offences so as to insulate them from any harm to their person;

g. To coordinate with and extend necessary expert, technical and logistical support to any other intelligence or law enforcement agency in India investigating crimes having cross-border, interstate or international ramifications that pose a threat to national security;

h. To enter into agreements for sharing of information and other cooperation with any central or state agency in India;

i. To enter into agreements for sharing of information and other cooperation with such agencies of foreign states as may be permissible under any international agreement or treaty; and

j. Any other matter relating to the above.

1.3 The Directorate is headed by a Director General of Income-tax (Intelligence & Criminal Investigation) and its headquarters is at New Delhi. There are 18 Director level posts designated as DsIT (I&CI). The DsIT (I&CI) exercise all the powers and functions related to and in connection with the collection, collation, verification and dissemination of information under the Income-tax Act, 1961 (the Act), including Sections 131, 133, 133A,133B, 134, 135, 285BA and corresponding provisions of Chapter XXI, Chapter XXI and other provisions incidental thereto. Each DIT (I&CI) has a defined territorial jurisdiction. However, all the DsIT (I&CI) also have all the powers and functions under Section 132 and corresponding provisions of Chapter XXI and Chapter XXII and other provisions incidental thereto of the said Act. In respect of these latter powers and functions, the territorial jurisdiction of the DsIT (I&CI) is Pan India.

1.4 At present the major responsibilities and functions of the Directorate involve:

i. Sole responsibility for collecting data and information from the Third-Party Reporting Entities.

ii. Enforcement of provisions of Section 285BA of the Act read with relevant Rules for ensuring correct and complete Reporting of Specified Transactions in the specified Format of SFT by the Specified Reporting Entities.

iii. Preparation of a Master Database of all the Filers of Information for monitoring compliance with respect to filing of SFT.

iv. Extending a helping hand and educating the Filers and spreading awareness amongst them about filing of information to the Department by way of conducting Outreach programs and Seminars on a regular basis.

v. Ensuring the correctness, accuracy and adequacy of information filed and verifying the same and issuing Notice *u/s* 285BA (4) in case of any Defective Return filed.

vi. Identifying the non-filers and making them comply by way of issuing Notices under Section 285BA (5)

vii. Ensuring deterrence against non-compliance by way of invoking Penalty proceedings *u/s* 271FA and 271FAA or relevant prosecution proceedings as laid down in the Act.

viii. Conducting Verification and Inspection to check the filing of data and its quality and adequacy.

ix. Conducting Enquiry of all Non-PAN and high value data passed on for verification and passing on the findings to the concerned Assessing Officers for necessary action and calling for Feedback on action taken thereof.

x. Acting as the Nodal Agency for receiving and verifying of all information received under 'Exchange of Information' from foreign authorities like FATCA (Foreign Tax Compliance Act, USA) and CRS (Common Reporting Standard from Non-USA jurisdictions) under the Automatic Exchange of Information (AEOI) and passing on the findings to the concerned Assessing Officers.

xi. Collecting data and information from areas or activities not exclusively covered or mandated by the Act by way of running Special Pilot Projects.

1.5 In simple terms, the role of the Directorate can also be said to be as under:

i. Widening of tax base through identification of stop filers and non-filers;

ii. Deepening of tax base by providing information for proper selection of cases for scrutiny assessments;

iii. Collection, collation and verification of information from internal as well as external sources and its dissemination to the field formations;

iv. Its mandate is also to identify and investigate of cases of tax evasion arising out of criminal matters, having any financial implication punishable as an offence under any Direct Tax Law; etc.

2. CORE FUNCTION OF DIRECTORATE OF I&CI

2.1 The core functions of the Directorate stem from Section 285BA of the Act read with the relevant Income-tax Rules, 1962 (i.e. Rule 114D to 114H) relating to the filing of Statement of Financial Transactions (SFT) by various entities etc. Previously, the furnishing of information relating to high-value financial transactions was known as 'Annual Information Return' (AIR). The AIR regime has now been modified into a system of furnishing of SFT and the Directorate has been entrusted with the work of intelligence gathering on this front.

2.2 Section 285BA of the Act mandates that 'specified persons' who are responsible for registering or maintaining books of account or other document containing a record of any Specified Financial Transaction (SPT) or any Reportable Account, as prescribed, must furnish prescribed statements in respect of the SPT or Reportable Accounts. The CBDT is empowered to prescribe different threshold values for different transactions for the purpose of their reporting. Rule 114B mandates that every person is required to quote PAN in respect of the specified transactions. These cover cases relating to high-value financial transactions like sale or purchase of motor vehicles, opening of certain bank accounts, issuance of debit/credit cards, opening of demat account etc. Similarly, transactions above certain specified limits involving purchase and sale of immovable properties, cash deposits, investment in shares,

mutual funds etc. are also covered. The specified persons are required to obtain the PAN of the respective parties involved or collect Form No. 60 in case of Non-PAN cases, as the case maybe. Thereafter, the specified persons are required to furnish the Statement of Financial Transactions (SFT) in prescribed Forms No. 61 and Form 61A.These SPTs are to be furnished to the Directorate of Income-tax (Intelligence & Criminal Investigation). The relevant Rules in this respect are Rule 114C, Rule 114D and Rule 114E. The various specified reporting persons have to file their SFT using their unique Identification Number, known as Income-tax Department Reporting Entities Identification Number or ITDREIN, in short.

2.3 The reportable accounts are more concerned with the obligations of a prescribed reporting financial institution as mentioned in Section 285BA(1)(k) of the Act. In order to facilitate effective exchange of information, Section 285BA provides for furnishing of statement by a prescribed reporting financial institution in respect of specified financial transaction or reportable accounts. The Income-tax Rules, 1962 were amended vide Notification No. 62 of 2015 dated 7th August, 2015 by inserting Rules 114F to 114H and Form 61B to provide a legal basis for the Reporting Financial Institutions (RFIs) for maintaining and reporting information about the Reportable Accounts. First, an entity needs to find out whether it is a Reporting Financial Institution. Then, the Reporting Financial Institution needs to review their financial accounts by applying due diligence procedures to identify whether any of the financial account is a Reportable Account. If any account is identified as a reportable account, then the Reporting Financial Institution is required to report the relevant information in Form 61B in respect of the identified reportable account. These are discussed in more detail in the subsequent part of this Chapter relating to FATCA (Foreign Account Tax Compliance Act) and CRS (Common Reporting Standard).

2.4 The SFT is a consolidated financial statement that eventually helps in creating a comprehensive database of the financial activities related to each PAN or transacting parties and this information is used to effectively check tax compliance, evasion, management of filing of returns and so on, thereby ensuring that all transactions which are recorded get reported and due taxes are paid thereon. The scope of SFT and the process of filing has been substantially changed in the year 2016. Therefore, running of outreach programmes and educating the filers has assumed critical importance for the Directorate.

3. PROCESS OF COLLECTION OF INFORMATION

3.1 The reporting entities are mentioned in Section 285BA(1) of the Act which includes besides an assessee, the prescribed person in the case of an office of the Government; local authority or any other public body or association; the Registrar or Sub Registrar under the Registration Act, 1908; the registering authorities under Chapter IV of the Motor Vehicles Act, 1988; the Post Master General; the recognised Stock Exchanges; an officer of RBI; a depository; the prescribed reporting financial institution; and, the Collector in case of land acquisition etc as declared therein. These persons are required to furnish a statement of Specified Financial Transactions or Reportable Account. Section 285BA(3) defines the Specified Financial Transaction to mean any prescribed transaction of:

a. Transaction of purchase, sale or exchange of goods or property or right or interest in a property; or

b. Transaction for rendering any service; or

c. Transaction under a works contract; or

d. Transaction by way of an investment made or an expenditure incurred; or

e. Transaction for taking or accepting any loan or deposit,

4. RELEVANT INCOME-TAX RULES

4.1 The Income-tax Rules, 1962 lays down the Rules specifying the transactions to be reported, persons required to report such transactions and the manner in which the report is to be prepared and filed. The relevant Rules are briefly mentioned below:

i. *Rule 114 B: Transactions in relation to which Permanent Account Number is to be quoted in all documents for the purpose of Clause (c) of sub-section (5) of Section 139A*

This Rule describes the set of transactions where quoting of PAN is mandatory for the persons entering into such transactions (See Notification No. 95/ 2015 dated 30th December 2015). If a person does not have any PAN and who enters into a specified transaction, then as per second proviso of Rule 114B, such a person is required to make a declaration in Form No. 60 giving therein the particulars of such transaction. The Rule 114B provides that the declaration in Form No.60 can be submitted either in paper form or electronically under the electronic verification code in accordance with the procedures, data structures, and standards specified by the Principal Director General of Income-tax (Systems) or Director General of Income-tax (Systems). In this regard the office of the Pr. DGIT(Systems) has issued Notification No. 1 of 2018 dated 5th April 2018 laying down the procedures for submitting Form No. 60.

ii. *Rule 114 C: Verification of PAN in transactions specified in Rule 114B*

The Rule mandates that the Reporting entities have to verify the PAN quoted by the concerned persons and have to ensure that the PAN is duly and correctly mentioned in the relevant documents. In case any person who does not have a PAN has furnished a declaration in form 60, then all such Form 60 declarations have also to be checked as to whether they have been properly filled up with complete particulars.

iii. *Rule 114 D: Time and manner in which persons referred to in Rule 114C shall furnish a statement containing particulars in Form No. 60*

This Rule specifies the time and manner in which the Reporting entities are required to submit a statement containing the particulars of Form 60. The data containing details of Form 60 is to be filled up in Form 61 and this has to be uploaded online by the Reporting entities. As per sub-rule (1) of Rule 114D, the persons referred to in Clauses (a) to (k) of sub-rule (1) of Rule 114C and sub-rule (2) of Rule 114C shall furnish a statement in Form 61 containing particulars of declarations received in Form 60 to the Director of Income-tax (Intelligence and Criminal Investigation) or the Joint Director of Income-tax (Intelligence and Criminal Investigation) through online transmission of electronic data to a server designated for this purpose and obtain an acknowledgement number. In this regard the office of the Pr. DGIT(Systems) has issued Notification No. 1 of 2018 dated 5th April 2018 laying down certain procedures. The procedures for registration and submission of Form No. 61 electronically has also been specified vide Notification No. 2 of 2018 New Delhi, dated 5th April, 2018. The reporting person/ entity is required to retain the Form 60 for a period of 6 years from the end of the Financial Year in which the transaction was undertaken.

iv. *Rule 114 E: Furnishing of statement of financial transaction*

The Rule 114E specifies that the details of all the specified financial transactions for the entire financial year, which includes both PAN and non-PAN data of the reportable transactions of

the financial year, are to be submitted by the specified person including the reporting entities in Form 61A. The Rule provides for taking into account all the accounts of the same nature in respect of a concerned person, aggregating all the transactions of the same nature by any concerned person, and apply the threshold limit separately to deposits and withdrawals. The Rule also lays down that where the account or transaction is in the name of more than one person, the entire value of the transaction or the aggregated value of all the transactions is to be attributed to each and all the persons.

The office of the Pr. DGIT(Systems) has issued Notification No. 13 dated 30th December, 2016 laying down the procedure for registration of the reporting entities for purposes of submission of SFT. The Notification also details the procedure to be followed to generate the Income-tax Department Registered Entity Identification Number (ITDREIN). Thereafter, the reporting entities are also required to get their concerned director or principal officer registered. The same was amended vide Notification No. 1 of 2017 dated 17th January 2017. As the functionality for submission of SFT has been subsequently enabled on the e-filing portal also, the office of the Pr. DGIT(System) has laid down a revised procedure vide Notification No. 3 of 2018 dated 5th April 2018.

Since the Proviso to sub rule (4)(a) to Rule 114E requires that the Post Master General referred to in Indian Post Office Act, 1898 or a Registrar or an Inspector General referred to in the Registration Act, 1908 are required to furnish the Form 61A in a computer readable media (CD or DVD), the office of the Pr. DGIT (Systems) has issued Notification No. 7 of 2017 dated 30th May 2017 laying down the relevant procedure in this regard. The same was amended vide Notification No. 1 of 2017 dated 17th January 2017 and also by Notification No. 3 of 2018 dated 5th April 2018.

v. Rule 114 F: Definitions

This Rule defines the crucial terms used in Rules 114G and Rule 114H.

vi. Rule 114 G: Information to be maintained and reported.

This Rule details the information which shall be maintained and reported by a reporting financial institution in respect of each reportable account. The Procedure for registration for submission of Statement of Reportable Account had laid down by way of a Notification No. 4 of 2016 dated 06th April, 2016 but after the launching of the 'Reporting Portal', the office of the Pr. DGIT (System) has laid down a revised procedure vide Notification No. 4 of 2018 dated 5th April 2018.

vii. Rule 114H: Due diligence requirement

This Rule lays down the manner in which an account can be treated as an reportable account and the due diligence procedure required to be followed.

5. FORMS

5.1 The various forms i.e. Form 60, 61,61A and 61B and their formats are prescribed under the relevant rules. These Forms are to be duly filled and uploaded on to the reporting portal by the persons/ entities which are required to report financial transactions.

a. **Form 60** is to be filled by an individual or a person (not being a company or firm) who does not have a permanent account number and who enters into any transaction specified in rule 114B[See Sec 139A(5)(c)].

b. **Form 61** is a Statement containing particulars of declaration received in Form no. 60.

c. **Form 61A** is a combination of entries which includes both PAN and non-PAN data of the reportable transactions of a financial year. There are 14 different types of Form 61A depending on the type of transaction and the reporting entity. These 14 SFT Types gives comprehensive

information on the type of transaction, value, date, identity of persons etc so that the same can be matched with the existing financial profile of the person. A Reporting person/ Entity is required to furnish separate Form 61A for each transaction type.

Categories of SFT Transaction

SFT- 001: Purchase of bank drafts or pay orders in cash

SFT- 002: Purchase of pre-paid instruments in cash

SFT- 003: Cash deposit in current account

SFT- 004: Cash deposit in account other than current account

SFT- 005: Time deposit

SFT- 006: Payment for credit card

SFT- 007: Purchase of debentures

SFT- 008: Purchase of shares

SFT- 009: Buy back of shares

SFT- 010: Purchase of mutual fund units

SFT- 011: Purchase of foreign currency

SFT- 012: Purchase or sale of immovable property

SFT- 013: Cash payment for goods and services

SFT- 014: Cash deposits during specified period (9th Nov to 30th Dec, 2016).

d. Form 61B covers reporting by the prescribed Reporting Financial Institutions, as defined under Section 285BA(1)(k). It is an annual statement of reportable account in respect of each account which has been identified, pursuant to due diligence procedure specified in Rule 114H, as a reportable account.

6. COMPLIANCE MANAGEMENT FUNCTION OF THE DIRECTORATE

6.1 The compliance management functions of the Directorate comprise the process of identifying the Entities/ Reporting Persons who are:

a. Not registered with Department,

b. Who are Registered but not filing the SFT Reports, and

c. Who are filing inaccurate reports.

6.2 Once the information is uploaded onto the System Database of the Department, the quality and adequacy of data is checked and necessary action taken through regular and periodic monitoring of the details of the third parties. The PAN based information received from the Filers is directly disseminated to the Assessing Officers through the System while cases of Non-PAN get passed on to the Directorate of I&CI for verification.

6.3 The Directorate is also required to reach out to and create awareness among the SFT filers as regards the provisions of the Act and the Rules impacting them and the procedures for filing of Statement of Financial Transactions. For this purpose, several outreach programmes are conducted by the Directorate from time to time. In addition, e-mails are sent to the registered members reiterating the need of filing SFT, if not already filed. Similarly, bulk SMS alerts are sent to the registered members as part of the programme for creating overall awareness regarding SFT.

6.4 Of late, due to sustained efforts of the Directorate, the offices of the Inspector General of Registrar & Stamps in many States are filing a single consolidated SFT.

7. SPECIAL PILOT PROJECTS

7.1 The Directorate of I&CI is uniquely placed to critically observe the different sectors of growth

in the economy and also discover the new methodologies being deployed by taxpayers to avoid payment of due taxes. Every year, with the approval of CBDT/ DGIT, the Directorate undertakes Special Pilot Projects to identify potential areas of tax evasion and this helps in deepening and widening of the tax base. Each such project is led by a particular DIT(designated as the Lead DIT).

The mandate of each of the Lead DIT is to:

1. Gather and collect data from the designated source in respect of the Special Project assigned, covering the jurisdiction of all the DsIT (I&CI)
2. Collate, sort and analyse the data pertaining to respective Special Projects and subsequently disseminate the data to other DsIT for carrying out further/ similar investigation and
3. Select cases from information gathered with respect to each Special Project and conduct verification.
4. Follow up on the investigation done by other DsIT in case of the Special Project and report to the DG.

8. FATCA & AEOI

8.1 To address the problem of offshore tax evasion and flow of illicit money, the two most important tools put in place in recent years are Foreign Account Tax Compliance Act (FATCA) and Automatic Exchange of Information (AEOI) under the Common Reporting Standard (CRS), in addition to the Double Tax Avoidance Agreements (DTAA) and Tax Information Exchange Agreements (TIEA) with different countries.

FATCA is a US law which was enacted in USA in 2010 to target non-compliance by U.S. taxpayers using foreign accounts. FATCA requires financial institutions to report information about financial accounts held by U.S. taxpayers or by such foreign entities in which U.S. taxpayers hold a substantial ownership interest. It is aimed at preventing tax leakage by US persons through use of offshore accounts and investments. Under this US law, for US-connected investments specified non-US entities such as financial institutions are required to disclose to the US Internal Revenue Service requisite information about their US accounts and the holder of such accounts. FATCA essentially provides for 30% withholding tax on US source payments made to Foreign Financial Institutions if the Foreign Financial Institution is non-compliant to FATCA. India has signed an Inter-Governmental Agreement (IGA) with the USA on July 9, 2015 and under the FATCA regime the financial institutions in India are required to report the required information to CBDT, which then exchanges the information on an automatic basis with the US-IRS. Similarly, the USA is also required to forward data relating to financial account of Indian Residents in the US to the competent authority i.e. FT & TR Wing of CBDT.

8.2 The Government of India had taken a leading role in building an international consensus amongst major economies of the world for free flow of financial account information, which can be exchanged amongst countries on an automatic basis. The OECD, working with all non-OECD G20 countries including India, has developed a single uniform standard for automatic exchange of information, the Common Reporting Standard (CRS) on Automatic Exchange of Information (AEOI). India has signed a multilateral agreement on June 3, 2015, to automatically exchange information based on Article 6 of the Convention on Mutual Administrative Assistance in Tax Matters under the CRS. The CRS is the agreed global standard for AEOI approved by the OECD in Feb 2014. The CRS contains the reporting and due diligence standards that underpin the automatic exchange of financial account information and

the rules and administrative procedures that an implementing jurisdiction is expected to have in place for effective implementation and compliance. In keeping with its leadership role, India was one of the early adopters of the new standard.

8.3 The Automatic Exchange of Information is a systematic and periodic transmission of "bulk" taxpayer information by the source country to the residence country, which is possible under most of the Double Taxation Avoidance Agreements and Multilateral Convention on Mutual Administrative Assistance in Tax Matters. The Multilateral Competent Authority Agreement (MCAA) provides a framework for exchange of information on automatic basis as per the new global standard. After joining the framework of the MCAA, the countries/ jurisdictions need to enter into bilateral/ multilateral arrangements for exchanging information subject to confidentiality and data safeguards requirements in the recipient country/ jurisdiction. The new global standard has a very broad scope and obliges the treaty partners to exchange wide range of financial account information after collecting the same from financial institutions in their country/ jurisdiction including information about the ultimate controlling persons and beneficial owners of entities. The financial information which would be exchanged would include account balance, interest, dividend and gross proceeds from sale and redemption of financial assets. The most common information with respect to AEOI are Interest and Dividend incomes, Income from independent/ dependent personal services, Other incomes, Royalty, Income derived from the activities of artistes, Pensions, Directors' fees, Income from immovable properties, Business profits, Income from government services, Capital gains and Payments to students etc.

8.4 For implementation of FATCA and CRS, necessary legislative changes were made through Finance (No. 2) Act, 2014, by amending Section 285BA of the Income-tax Act, 1961. The Income-tax Rules, 1962 were also amended vide Notification No. 62 of 2015 dated 7th August, 2015 by inserting Rules 114F to 114H and Form 61B to provide a legal basis for the Reporting Financial Institutions (RFIs) for maintaining and reporting information about the Reportable Accounts. While Rule 114F deals with Definitions, Rule 114G deals with Information to be maintained and reported and Rule 114H with due diligence requirement for operationalization of FATCA, IGA and CRS. This information regarding reportable persons and reportable accounts have to be furnished in Form no. 61B.

8.5 A Guidance Note was released on 31st August 2015 to provide guidance to the Financial Institutions, Regulators and officers of the Income-tax Department for ensuring compliance with the reporting requirements provided in Rules 114F to 114H and Form 61B of the Income-tax Rules, 1962. The Guidance Note is intended to explain the complex reporting requirements and provides further guidance wherever required. This Guidance Note was updated on 31st December 2015 to address evolving issues in the implementation of FATCA and CRS. Further clarifications on the same have also been issued from time to time, with the last update on 30th November 2016.

8.6 The Directorate of I&CI has been designated as the nodal Directorate for monitoring of compliance by the financial institutions under FATCA and CRS.

9. COMPLIANCE REVIEW OF FATCA

9.1 The Compliance Review of filing of Form 61B has to be carried out in accordance with the SOP approved by the CBDT vide its letter dated 26.07.2017. The review is to be carried in two stages:

a. Prior to filing of Form 61B, and

b. Post filing of Form 61B

9.2 Further in this direction, a task force for Indo US Dialogue for Collaboration on Offshore Tax Compliance formed by FT & TR has been constituted to deal with issues related to offshore tax compliance enforcement and improvement in the quality and usability of data. The task force is expected to lay down the SOP for handling of outbound and inbound FATCA data.

9.3. Compliance function Prior to filing of Form 61B: The Rule 114F, 114G and 114H provide statutory requirement to the filers to file relevant information in compliance to FATCA. The Financial Institutions (FIs) are required to submit a report in Form 61B in respect of reportable accounts in accordance with the Rules. The Rules also lay out mechanisms for due diligence to be made by the FIs in determining the reportable persons and accounts. Rule 114G requires a financial institution to register with the Income-tax Department for purpose of reporting compliance under FATCA/ CRS. After registration, the FIs can file the Form 61B indicating the reportable accounts. The Nodal DIT (DIT Delhi) seeks information from sources like SEBI, RBI, Depositories, IRDA etc. to identify entities required to register for FATCA/ CRS compliance. The master list is constantly updated. A list of the registered entities is provided by the Directorate of Systems to the Nodal DIT on an updated basis through a system enabled portal on ITBA. Entities who have not registered are advised by the Nodal DIT/ jurisdictional DIT to register. The Directorate of Systems also provides the information (through a dedicated portal) about those registered FIs who have not filed a NIL report or a non NIL report by 30th June for statements filed on or before 31St May. Electronic communication is then made with these entities for removal of deficiencies, if any. To ensure proper compliance regarding complete and correct information, guidance/ outreach programs are conducted in co-ordination with FT & TR Division and Systems Directorate to sensitise FIs regarding their obligations under the FATCA/ CRS Reporting System.

9.4 Compliance function Post-filing of Form 61B: For the post filing review, the Directorate of Systems provides the details of accounts filed in part A and Part B of the report segregated on the basis of PAN jurisdiction of the FIs to the Directorate of I&CI. The concerned DIT then selects 10% of the FIs in its jurisdiction on the basis of:

i. Volume of accounts reported,

ii. A comparative study of the ratio of the total number of account maintained by the institution and

iii. The accounts reported or any other indicator which is found useful for preliminary verification.

9.5 As far as possible, FIs of each category, namely Depository Institution, Custodial Institution, Investment entity and Specified Insurance Company are picked up for preliminary verification.

9.6 Thereafter, a performa in standard format including information indicators, due diligence time frames, total number of accounts present, compliance to due diligence procedures, determination of accounts, self-certification process, compliance to specific record maintenance etc. is forwarded to the selected FIs for the purpose of review. Subsequently, a risk based assessment for picking up cases for detailed compliance review inspection is carried out after detailed scrutiny of the information provided in the performa. Detailed inspections and spot verifications are also carried out in selected cases. The DIT is required to submit a complete inspection report in such cases. On the basis of verification, the outcome in actionable cases are reported to the field for further action besides recommending penalty *u/s* 43 of Black Money Act and prosecution etc.

10. COMPLIANCE REVIEW OF AEOI

10.1 Inward Data: In respect of data received by the Directorate, the Compliance function of the Directorate is as under:

a. The data under the AEOI including reportable account is received by the competent authority i.e. the JS(FT&TR), from his counterpart in another country/ jurisdiction. This data is forwarded to the DGIT(I&CI) in a secured manner. The office of DGIT is required to access the data, examine its integrity and convert the data into usable format with the help of a utility provided by Pr. DGIT(Systems).

b. The data is then segregated into PAN and non-PAN categories.

c. Efforts are made to populate PAN in the non-PAN data/ information, wherever possible, with the help of a utility required to be provided by Pr. DGIT(Systems) or by using alternate methods till the utility is made available.

10.2 Non-PAN Inward Data: Out of the final Non-PAN data, cases are selected for inquiry by the designated nodal officer DIT(I&CI), New Delhi, on the basis of monetary threshold limit or any other criteria as prescribed by DGIT(I&CI) for a particular financial year as under:

a. The selected cases are forwarded by the nodal officer to the jurisdictional, DIT(I&CI) for assigning the case for inquiry to an officer in his jurisdiction. Afterwards, the inquiry report on actionable cases is sent to the jurisdictional PCIT/ CIT for taking necessary action as per the provisions of the Income-tax Act, 1961.

b. The Non-PAN data which is not taken for scrutiny by the nodal officer are linked to additional information subsequently received in that case for inquiry. The nodal officer also may provide this data to the Investigation Wing on request.

10.3 PAN Inward Data: The PAN data is sent by the nodal officer to the Pr. DG(Systems) to verify the same vis-a-vis the Income-tax returns to find any discrepancy and intimate case-wise result to the nodal officer and also forward the undisclosed transaction to the assessing officer for necessary action, where assessment is pending. However, where an assessment is not pending or return of income is not filed, the data is forwarded to the Directorate of I&CI. The nodal officer segregates the data on the basis of a monetary threshold to be decided by DGIT(I&CI) with the approval of CBDT and forward this data to the respective DIT for inquiry. The data below the monetary threshold gets forwarded to the Pr. CCIT (CCA) concerned for inquiry. During inquiry, either by the officers of I&CI or by the assessing officer, if the person to whom the information relates denies the transaction fully or partly or does not respond to the notices issued by the officer who is conducting the enquiry, the officer concerned may obtain the evidence in respect of that transactions from the treaty partner as per the procedure prescribed in Chapter III of the Manual for Exchange of Information to complete the enquiry/ proceedings.

10.4 Outbound Data: For sending the data, the financial Institutions have to report the accounts by 31st May following that year. The Department has to exchange this information as per prescribed time schedule with the jurisdiction of tax residence of the account holder where there is a legal basis to do so.

10.5 Project Insight and FATCA/ CRS: The Project Insight is also being leveraged for implementation of FATCA and CRS. Under this project an integrated data warehousing and business intelligence platform is being rolled out in a phased manner. The project also operationalizes two new centres namely Income-tax Transaction Analysis Centre (INTRAC) and Compliance Management Centralized Processing Centre (CMCPC). The INTRAC leverages data analytics in tax administration and performs tasks related to data integration,

data processing, data quality monitoring, data warehousing, master data management, data analytics, web/ text mining, alert generation, compliance management, enterprise reporting and research support. The CMCPC uses campaign management approach (consisting of e-mails, SMS, reminders, outbound calls, letters) to support voluntary compliance and resolution of compliance issues. A dedicated compliance portal shall be used to capture response on compliance issues in a structured manner for effective compliance monitoring and evaluation. It will help monitor flow of funds and provide an audit trail of high value transactions.

As a part of this Project, a Reporting Portal has been setup to collect information from various Reporting Entities. The portal can be accessed at https://report.insight.gov.in. The reporting portal has been designed as an integrated portal for all third-party reporting activities. It provides seamless data processing & quality monitoring; data encryption for enhanced security; seamless information exchange with reporting entities; comprehensive resources module for capacity building; seamless reporting entity compliance management and a dedicated helpdesk support

11. SALIENT ASPECTS OF REPORTING OF REPORTABLE ACCOUNTS

11.1 Report Type: The Form 61B has two parts, Part A is 'Statement Details' and Part B is 'Report Details'. In Part A, the field 'Report Type' (rowA.2.7) has only two permissible values:

1. Report of US reportable accounts under Rule 114G, and
2. Report of other reportable accounts under Rule 114G

The above distinction is on the pattern of difference between a FATCA case and CRS case. One statement can contain only one type of report.

11.2 Reporting Financial Institution: As per Rule 114F(7) "reporting financial institution" means:

a. Financial institution (other than a non-reporting financial institution) which is resident in India, but excludes any branch of such institution, that is located outside India; and

b. Any branch, of a financial institution (other than a non-reporting financial institution) which is not resident in India, if that branch is located in India.

An entity needs to find out whether it is a reporting financial institution (RFI). The RFI needs to review financial accounts held with it by applying due diligence procedure to identify whether any financial account is a reportable account. If any account is identified as a reportable account, the RFI shall report the relevant information in Form 61B in respect of the identified reportable accounts.

11.3 Reportable Account: As per Rule 114F(6) "reportable account" means a financial account which has been identified pursuant to the due diligence procedure provided in rule 114H, as held by:

i. A reportable person; or

ii. An entity, not based in United States of America, with one or more controlling person that is a specified U.S. person; or

iii. A passive non-financial entity with one or more controlling persons that is a person described in sub-Clause (b) of Clause (8) of the rule 114F.

11.4 Reportable Person: As per Rule 114F(8) "reportable person" means:

a. One or more specified US persons; or

b. One or more persons other than:

i. A corporation the stock of which is regularly traded on one or more established securities markets

ii. Any corporation that is a related entity of a corporation described in item (i);

iii. A Governmental entity;

iv. An International organisation;

v. A Central Bank; or

vi. A financial institution

—that is a resident of any country or territory outside India (except the United States of America) under the tax laws of such country or territory or an estate of a decedent who was a resident of any country or territory outside India (except the United States of America) under the tax laws of such country or territory.

12. VERIFICATION OF TRANSACTIONS

12.1 Presently, there is no requirement of physically receiving the data in Form 60 and Form 61 (old version), as the same would now have to be uploaded online in one consolidated Form 61 by the reporting entities.

12.2 For the purposes of verification of the transactions, the basic SOP can be on the pattern given below which factors in the experiences under both the AIR and SFT regime. This SOP below discusses the methodology in totality. While the erstwhile regime of AIR would cover cases for FY earlier than FY 2016–17, the data collected in SFT and sent by the Systems Directorate would pertain to FY 2016–17 onwards.

Standard SOP for Verification of Non-PAN/ Invalid PAN in High Value Financial Transactions

Objective	The objective of verification of Non-PAN/ Invalid PAN cases by the officers of the DGIT(I&CI) is widening and/ or deepening of tax base in terms of number of new assesses added/ additional tax collected.
Selection of cases	Selection of cases has to be strictly in accordance with the guidelines as laid down by the DGIT(I&CI) and any other directives issued for this purpose. The verification will be in respect of Non-PAN/ Invalid PAN cases pertaining to AIR data (under sub-codes Sale/ Purchase of Immovable Property, Cash Deposits & Form 60/ 61), CIB data, and any other residual field of AIR, if applicable, as are reported in SFT/ AIR/ CIB transactions relating to the Financial Year. The selection will be done using data analysis software by identifying potential high risk cases where a person has transacted multiple codes under AIR and/ or where a person has done high value transactions across codes of CIB (*viz.* Cash deposits between Rs. 5–10 lakhs & Immovable Property Transactions < 30 lakhs). This would provide cases of multiple entries of high value transactions done by an individual. If the process of non-PAN AIR analysis across codes/ years does not yield any cases, the cases which have higher transaction values (aggregate terms) should be considered for selection. The threshold value for AIR/ CIB transaction is fixed as under: Cumulative Cash deposit in a year above Rs. 50 lakhs (Rs. 25 lakhs in mofussil stations*) Sale or Purchase of property above Rs. 1 Crore (Rs. 50 lakhs in mofussil stations*) 50C Cases Form 60/ 61 cases above Rs. 10 lakhs. Suitable CIB data under all codes/ Projects. Any other residual field of AIR, if applicable. *"Mofussil Stations" shall mean all stations other than metropolitan cities of Ahmedabad, Bangalore, Chennai, Hyderabad, Kolkata, Mumbai, New Delhi and Pune. The cases are to be selected from the top in each of the categories of cases mentioned in paras (ii) and (iv) hereinabove. While selecting cases from each category, weightage of 20%, 60% and 20%, respectively, is to be given to Cash Deposits, Immovable Property and Other categories listed at (iv) of SOP above. The above basket of cases should be subjected to ITS/ ITDMS search to populate PAN. In cases where PAN is found, it should be ascertained from ITD System whether ITR is filed and the transaction is reflected in the ITR.

	At this stage, the basket of cases would comprise the following categories of cases: Cases where no PAN could be found; Cases where PAN is found and populated but ITR is not filed; Cases where PAN is found and populated but the transaction is not reflected or only partly reflected, in the ITR filed. In a scenario where the case is found to be already selected for scrutiny and the reason is same transaction or any other, selection of such cases may be dropped. Cases where PAN is found and the transaction is reflected in the ITR filed. Selection of cases should be made only from (a), (b) & (c) of para (ix) above. The minimum number of cases picked up in a year for verification should be 100 for each ADIT/ DDIT (as ADITs/ DDITs will also be dealing with verification of AEOI and FATCA cases) and 200 for each ITO working in the DIT charge. Where the required number of cases is not available, the threshold limit/ percentage value in paras (iv)& (vi) hereinabove may be suitably relaxed to get the desired number of cases for verification. Wherever it is felt that there is scope for further verification, for example in connected cases of co-owners/ POA holders of property/ mortgage deeds etc., the DITs can select such cases. Where there is scope for further verification in connected cases *u/s* 56(2)(vii)(b) & 43(CA), the DIT can take up such cases for verification. The work of selection of cases should be completed by 30th September of the financial year and a report in this matter is required to be submitted by 7th October, to the DGIT(I&CI), New Delhi along with the number of cases selected.
Purpose of Verification	To verify the source of Investment/ funds and taxability of the same. Any claim of loan, gift from close relatives or claim of agricultural income should be verified and a finding may be given. To verify as to whether the income shown in the ITR is commensurate with the investments made. To verify as to whether any taxable income/ capital gains arising out of the high value transaction being verified has remained undisclosed to the Department. PAN, if obtained in any level of verification, should be uploaded/ populated in the ITD System.
First level of verification	In the first level of verification, notice under Section 133(6) should be issued to confront the person concerned with the information available with the Department and seek explanation with supporting evidence. In cases where PAN was not found at the stage of selection, the purpose of the notice *u/s* 133(6) is also to find PAN of such entities. At this stage there could be three possibilities: Where reply is received and explanation is found to be satisfactory and supported by evidence. Where reply is received but explanation is not found to be satisfactory/ not backed with adequate evidence. No reply is filed. In case of (a)of para II above, a closure report mentioning the findings in the case should be submitted to the Addl. DIT/ Jt.DIT and the verification may be closed with the approval of DIT after populating the PAN. In case of (b), second level of verification should be carried out. In case of (c), it may first be ascertained whether the notice has been duly served. If notice remains un-served in view of incorrect address, proper verification has to be carried out to ascertain the correct address through ITDMS/ any other means to get the notice served. In such cases where notice remains un-served, physical verification may be done through Inspectors and, if thereafter the party remains untraceable and no forwarding address is also available, the case may be closed with the approval of the DIT concerned.
Second level of verification	In the second level of verification, proceedings *u/s* 131 of the Income-tax Act, 1961, may be resorted to undertake a more detailed enquiry in cases where: The notice has been served & the party has not responded even after 02 reminders, or The reply received is not found to be satisfactory. If the reply received is found to be satisfactory, and backed with evidence, the case may be closed with the approval of DIT. Where the reply received is not satisfactory, the case is to be considered for third level of verification.

Third level of verification	The third level of verification shall be conducted primarily in cases: Where it appears that the transacting party has wilfully or deliberately not responded to the notices/ reminders seeking information; Where the officer feels, with evidence, that the transacting party has suppressed the information which it is supposed to file; Where the results of second level of verification indicate large-scale irregularities and non-disclosure of taxable income/ capital gains. In such cases, a proposal should be put up to the Addl.DIT/Jt.DIT by the concerned officer for conducting inquiry/ survey *u/s* 133A and, if found necessary, such action may be resorted to with the prior approval of DIT concerned. The findings of the above inquiry/ survey *u/s* 133A should be submitted in the form a self-contained report to DIT through the Add.DIT/Jt.DIT, and a copy forwarded to DGIT(I&CI), New Delhi.
Timeline	Verification should be completed within 3 months of assigning the case for verification.
Reporting	Findings of first/ second/ third level of verifications must be put up in the form of self-contained report to Addl. DIT/Jt.DIT, who will put up the same with his comments to the DIT for final acceptance/ further directions, if any. Where the findings of first/ second/ third level of verification is adverse and requires action *u/s* 142(1)/ 143(2)/ 147 by the AO, the findings along with evidence collected during verification process must be forwarded to the field authorities as follows: In PAN cases, the results of enquiry along with evidence collected must be forwarded to jurisdictional AO with a copy to CIT concerned. In non-PAN/ Invalid PAN cases, the report should be sent to field CIT having territorial jurisdiction over the case.
Feedback	While sending the report to the field authorities, a feedback should be requested for in the prescribed format regarding action taken on the verification report, within 2 months of dissemination of report as mentioned above.

13. MANNER OF VERIFICATION OF TRANSACTIONS

13.1 An instance of a general SOP used for verifying AIR/ SFT Non-PAN data: This SOP directs as under:

"In order to standardize the whole process of verification, the Directorate of I&CI directs its officers to follow the following detailed work processes:

i. DIT(I&CI)'s mandate is intelligence gathering and for that ITOs/ DDIT are required to ask for details from transacting parties and carry out necessary verification/ enquiry. Care should be taken not to exceed this limit, meaning thereby, ITOs/ DDIT are not supposed to do on-spot assessment.

ii. For Non-PAN AIR/ SFT Data for verification & PAN population, efforts are being taken to adopt methodology for aggregation of same transacting party with the same ITO/ DDIT.

iii. Unique Reference No is generated for these transactions which need to be referred in all correspondences which will help in proper tracking. e.g. Reference No will be DIT(I&CI)/ AIR-SFT Verification-FY2015–16/ 1…./ ITO-…./ 2017–18/ dt……..

iv. Formal approval is given to call for relevant details *u/s* 133(6) of the Act pertaining to both the transacting parties of the assigned cases for verification.

v. Sample questionnaires pertaining to Sale Deed enquiry, cash/ bank deposits, Vehicle purchase/ High Value transaction/ Insurance premium surrender, benami transaction etc are prepared.

vi. IG (Stamps & Registration) has been formally requested to provide scanned

copies of registered sale deeds or their transaction ID and on receipt of the same, all details in CD is provided to each ITO/ DDIT. The same can also be requisitioned *u/s* 133(6) from the transacting parties.

vii. With regard to land registry, other details e.g. distance from urban settlement/ Municipal/ Local bodies, the boundary limit can be downloaded from www.google.com. Whether agricultural land is irrigated or not, for that, the Jurisdictional Tehsildar can be requested to provide the report. Apart from this, other details as available in the Registered Sale Deed needs proper analysis.

viii. On receipt of Registered Sale Deed, ITO/ DDIT should try to retrieve the bank/ cheque details available therein and ask for bank statement/ cheque payment details preferably through e-mail from the bank itself.

ix. The DLC Rate details of various region and urban colonies, relevant details is also provided.

x. Sample Order-sheet Noting are given in a CD to be strictly followed by all.

xi. Detailed write up and case laws pertaining to Sec 2(14), 48, 50C, 54, 68, 69, 69A, 69B & 69C are also given in Case laws folder of the CD.

xii. Final Report should invariably contain details as under:

a. Transaction and transacting parties' details.

b. Modes of payment/ receipt

c. Capital gain/ income arising out of the transaction offered for taxation or not?

d. Investment made from disclosed sources or undisclosed sources and they are verifiable from the I T Return & bank statement?

e. Income-tax Return filed by the transacting parties for the year and prior to current year showing particulars of income.

f. Whether is it a case of evasion of capital gain or income for which reference is required to be made to the Jurisdictional CIT.

g. Transacting parties have made proper compliance to explain the transaction or not?

h. What is the limitation date for taking remedial measures if any by the AO.

xiii. All transaction should invariably be examined from the angle of Benami Transaction Act also. In such case, all documentary evidences (along with oral evidences in form of sworn statement) and Annexure-III (Duly filled in) should form a part of the report to the Designated Initiating Officers (IO) of the BPU for which a prior approval of DIT(I&CI) must be taken without any further delay.

xiv. In the Report to the AO, no recommendation for action *u/s* 147 of the Act should be made. The language in the Final Report should be "on the basis of evidences gathered so for, it is seen that capital gain arising out of this transaction not offered for tax in the year/ documentary evidences pertaining to claim u/ s 54F not provided/ complete particulars of computation of capital gain not given/ investment remained unverifiable and undisclosed/ income arising out of this remained undisclosed and untaxed…therefore, AO is required to take remedial measures as deemed fit." (strike off unrelated portion). All documentary evidences in original, properly indexed should form a part of the said report.

xv. Efforts are being made to also send the report in digital format through e-mail to the Jurisdictional CIT. However, in addition to the digital copy, hard copy of the report will also be sent.

xvi. The Final Report submission subsequent to verification process has to be completed within 90 days. For further extension in submission of final report in the specific case has to be sought by giving proper reasoning.

xvii. Final report along with all evidences gathered will be sent under the signature of DIT(I&CI) to the Jurisdictional CIT with a copy to CCIT. For time barring/ limitation matters, proper care should be taken so that final report should reach to the table of the AO concerned at least clear 90 days ahead of the limitation date.

2. On perusal old case records and also with discussion with Pr. CsIT, it is learnt that officers of the Directorate are routinely forwarding enquiry report where actionable points are missing, with recommendation to take remedial measures *u/s* 147 of the Act. Further, it is also learnt some AOs are also refusing to take cognizance of reports pertaining to Non-PAN Data. Keeping in mind the various provisions for taking remedial measures to tax undisclosed income or undisclosed investment, it is desired that same procedure should be followed by all units of this Directorate without any failure as detailed in para above. The detailed SOP to be followed is as under:

Stage 1: Data/ details gathered so far to be disseminated to the Officers by this Directorate, and for that they are required to complete the verification/ enquiry within stipulated deadline invariably within 90 days. Before sending requisition *u/s* 133(6) of the Act, format of letter has also to be approved, just to maintain uniformity across this Directorate. For your reference, sample questionnaire is given in para below.

Stage 2: Submission filed by assessee has to be analysed properly. If the situation so arise, assessee will be required to be examined on oath *u/s* 131 of the Act, for that seek necessary notice from DDIT(I&CI). While examining on oath, assessee has to be asked about:

a. A brief note on nature of business carried out during the year and also on transaction made (as referred)

b. His/ her complete details, address, Mobile no, PAN, Aadhaar and his/ her financial status

c. Filing of returns, returned income for previous 3 AYs

d. Bank account through which transaction was routed

e. Modes of payment/ receipt

f. Date of transaction.

g. Details of other transacting parties/ party.

h. If funds provided by others, then ask him to clarify and specify which should bebacked by documentary evidences?

i. Nature of business carried out by the transacting parties

Stage 3: Enquiry Report to be submitted through Addl. DIT as below: If Addl. DIT is on leave/ on training, then file has to be sent directly to the DIT(I&CI) with a summary sheet (to be prepared by Inspector of the Office of Addl./Jt.DIT).

(a) Self contained enquiry report should have details as under:

1. Enquiry assigned vide letter dt. …. Pursuant to this, letter asking for details *u/s* 133(6) of the Act issued and served on the assessee. If not served, then ask Inspector attached with your office to personally serve the same. Still unable to serve because of incomplete address, please mention the same.

2. Facts in brief, highlighting the transaction, transacting parties, their PAN, modes of payment/ receipt, bank statement highlighting those transactions, copy of Income-tax return for the AY along with computation sheet, date of transaction FY/ AY thereof and other documentary evidences gathered so far.

1. Also mention any oral evidence in form of sworn statement recorded on oath *u/s* 131 of the Act has been
2. Clearly specify whether the said transaction is verifiable or remains unverified/ part verified.

3. Specify the undisclosed/ untaxed income/ investment portion.

3. Specify Jurisdictional AO, Additional CIT Range and Pr. CIT and finally making recommendation to take remedial measures by the AO as deemed fit to tax the undisclosed income/ investment mentioned above. If it pertains to time barring matter, then clearly specify that for taking remedial measures *u/s* 263/ 147, limitation date will expire on such date.

a. If in that case scrutiny proceedings are going, then without any failure, details pertaining to that transaction have to be enquired and in case of any discrepancies noticed, then AO/ Addl. CIT/ Pr. CIT has to be informed immediately.

b. Only in case of actionable information, enquiry report has to be forwarded to the AO. In all other cases, file will be recommended for closure

4. Now procedure is required to be followed in sequence detailed as under:

a. Order sheet of the case record: It should contain all events starting from case assigned to you as case record travels from you to DIT(I&CI).

b. After taking due approval, an enquiry letter *u/s* 133(6) of the Act asking for details to be issued to both the transacting parties.

c. Mention details of enquiry proceedings in the order sheet.

d. Enquiry has to be conducted within the stipulated deadline (mentioned in the letter while assigning the case). If enquiry is still pending then seek approval of the DIT(I&CI) again. On the order sheet, put up the gist of the matters as mentioned above in (a)(1 to 6).

e. Enquiry report should contain all points as mentioned in (a)(1 to 6),

f. Additional DIT (I&CI) should also examine the report and make specific recommendation of "closure" or "making further reference to the AO" specifically mentioning the undisclosed income/ investment. If Additional does not agree with the enquiry report, he/ she should specifically ask to carry out specific investigation. But it has to be kept in mind that "in this Directorate we are required to collect details, no to do any assessment". If Additional DIT is on long leave or on training, then file should be put up by the office of Addl DIT(I&CI) directly to this office without any further delay.

g. Each transaction has to be also seen from the angle of Benami Transaction Act also, for which a separate SOP has also been put in place.

h. For time barring matters, enquiry report is required to reach AO's office at least 90 days prior to the limitation date. For any deviation, you are required to seek further approval from DIT(I&CI).This has to be strictly followed without any exception.

i. Unless majority of backlog of old pendency of verification cases(if it is more than 100 case) are cleared, no new cases will be assigned to the officer concerned. Old

pendency has to be given top priority and they are supposed to be cleared in time bound manner within prescribed deadline.

5. To summarize, the travel path of an individual file will be as under:

a. Transaction details for verification, along with photo copies of Form 60/ 61 & reference no will be given to ITO/ DDIT(I&CI). Proper entry of these transaction will be made in the PC of office of Addl/ Jt DIT and DIT(I&CI). Proper approval given for calling for details *u/s* 133(6) of the Act from both the transacting parties.

b. Notice *u/s* 133(6) along with detailed questionnaire to be issued to both the transacting parties simultaneously.

c. Details gathered should be properly analysed and then a final report suggesting closure or making a reference for taking remedial measures as deemed fit by the AO should be prepared and the case record with proper noting of order sheets should reach the office of Addl./Jt. DIT who after careful examination of the same will forward to the DIT(I&CI). Only in case of long leave or training of Addl./Jt.DIT, file will be marked to the office of DIT(I&CI). In such case, Inspector attached to the office of Addl./Jt. DIT will make a summary note of the enquiry.

d. File will then be examined and further course of action will be decided by DIT(I&CI). HQ Office will prepare a forwarding letter for the cases to be referred to the Jurisdictional CIT. Outstation office of Kota, Udaipur and Jodhpur shall submit every fortnight the final reports after properly examining the evidences gathered and also indexing the same to the office of Addl./Jt. DIT. In case of further reference to the AO, office of the DIT HQ will prepare the forwarding letter. It is desirable that scanning of documents should be done by the office of ITO Kota, Udaipur and Jodhpur and copy of the same should be provided in Pen drive to the office of DIT(I&CI).

e. Hard copy of the letter along with the report should be sent to the Jurisdictional CIT within 3 days of approval of the report, whereas an advance copy of report should be sent by e-mail so as to avoid any delay. Whole process of verification should be completed within 90 days and further extension will be allowed only with prior approval of DIT(I&CI) only. For record purpose, Photo-copy of the order-sheet along with forwarding note will be given to office of DIT(I&CI) for updating the database.

14. SAMPLE QUESTIONNAIRES

14.1 A sample of standardized questionnaire for Registered Sale Deed Verification in land transaction/ residential property/ commercial property case has been prepared for both the buyer and seller separately for a standardized and uniform verification. Similar standardized questionnaire for cash deposits in Bank, issuance of shares at a premium by unlisted companies, for investment in shares at a premium issued by unlisted companies, payment for insurance premium/ surrender of policy, verification of e-Commerce transactions, STT verification, verification of off-market transactions have also been prepared for uniformity in verification process.

14.2 Cases under Prohibition of Benami Property Transactions Act, 1988:

While examining such transaction, the focus of verification is on the following aspects:

- *Who has made the payment? Whether it has been made from his/ her known sources or not?*

- *Whether he/ she is a man of means or not?*
- *Whether it is a shell company?*
- *Whether only arrangements have been made to camouflage the whole transaction?*
- *Ask for IT Returns and bank statements to substantiate his/ her claim.*

After analysing the transaction, if it falls within the purview of Benami Transaction Act, then all original documentary evidences along with copy of sworn statement recorded on oath u/s 131 of the Act has to be properly indexed and the file put for approval with Annexure below duly filed in before referring the matter to the BPU.

Annexure

Performa of information of benami transaction/ property to be sent to the Initiating Officer(IO)
(Separate annexure for each benami property/ transaction)

1	*Particulars of the real owner (such as name, address, PAN/ Aadhaar)*	
2	*Particulars of the benamidar (such as name, address, PAN/ Aadhaar)*	
3	*Particulars of the benami property/ transaction, including description of the property such as particulars & address, etc., of immovable property; bank account number with name & address of the bank; Demat account number with name & address of the financial institution, etc.*	
4	*Approximate fair market value of the benami property/ transaction (in Rs ___lakh)*	
5	*Specific facts and evidences (including statement, documents, etc.) indicating it to be a benami transaction/ property within the meaning of the provisions of Section 2(9) and 2(8) of the Act (to be enclosed along with this)*	

15. INSPECTION

15.1 As a part of compliance management programmes, spot verification and inspections are also conducted by the Directorate. The process of inspection of AIR/ SFT filers is carried out under the provision of Section 133A of the IT Act with due approval of Jt./Addl. DIT (I&CI). The entity selected for inspection is required to provide necessary facility to inspect their books of account and documents in order to verify the reportable transactions.

16. PENAL PROVISIONS IN CASE OF DEFAULT

16.1 Failure to furnish Statement of Financial Transaction or Reportable Account can lead to imposition of penalty under Section 271FA of the Act. If a statement is not furnished within the time prescribed, a penalty of Rs. 100/- per day of delay, can be imposed for every day during which the default continues. If the statement is not furnished in spite of a notice having been issued under Section 285BA(5), a higher penalty of Rs. 500/ is leviable per day of default beginning from the day immediately following the day the time specified in the notice expires.

16.2 Failure on the part of a prescribed reporting financial institution to furnish accurate Statement of Financial Transaction or Reportable Account can lead to levy of a penalty under Section 271FAA amounting to Rs. 50,000/-.

CHAPTER

21

Investigation through Satellite Imagery

1. Satellite imagery comprises of images of Earth collected by imaging satellites operated by governments and businesses around the world.

2. Remote sensing is a key technique used to obtain information related to the earth's resources and environment (physical, ecological, infrastructural, etc). Satellite imagery data can be easily accessed online through various mapping applications like Google Earth or government organisations like ISRO. Google Earth is a desktop application that works on Linux, Mac and Windows operating systems. It can easily be downloaded and locations can be found through accessing it through the search bar.

3. Remotely sensed satellite images and data include spectral, spatial and temporal resolutions. Spectral statistics involves elements of remotely sensed image classification. The main aspect which influences the accuracy of ground object is spatial resolution which is the pixel size of an image representing the size of the surface area. Temporal resolution helps in generation of land cover maps for different period of time as it is the amount of time (e.g. days) that passes between imagery collection periods for a given surface location.

4. Satellite imagery can assist an Assessing Officer/ Investigator to track commercial and residential real estate; identify land use, check when new buildings comes up (relevant for deduction *u/s* 80-IB) within the confines of his office. The same exercise, if conducted physically through traditional means would be a time and resource-consuming affair.

5. The two best sources for obtaining such satellite images are Google Earth and ISRO (Indian Space Research Organisation). Though Google Earth images are better in the sense of the resolution offered by them but the images from ISRO would carry more evidentiary value in the appellate system.

6. The highest-resolution imagery displayed by Google Earth is around 60cm, which means that each pixel on a computer screen will represent 60cm on the ground. This is high enough resolution to view roads, construction, field change, even individual trees.

7. APPLICATIONS OF SATELLITE IMAGERY IN INCOME-TAX INVESTIGATION

7.1 Agricultural Income

It can be used to identify whether any agricultural activity has been carried out on a particular piece of land in the past. Historical satellite images are available for various dates which can be accessed to know whether the land was ploughed, cultivated and whether there was a standing crop, etc. It can be used to verify claims of agricultural income, exempt capital gains from sale of agricultural land, etc as exemption is given only if the land has been used for agriculture purpose for at least two years before the sale.

7.2 Construction

Satellite images can be used to verify the activities that have been performed on land to get an idea about the expenses claimed on land leveling, fencing, etc. It can be used to verify deduction claims *u/s* 80IB (10) by ascertaining the period when work commenced and completed in respect of a particular project.

7.3 Wealth Analysis

Satellite images can be used to study assessee's lifestyle, such as cars outside his home, a new storey built on his house or to look at the state of renovations or repairs to check whether those are same as disclosed in ITRs.

8. SAMPLE INVESTIGATION FOR DETERMINATION OF AGRICULTURAL INCOME USING SATELLITE IMAGERY

8.1 Whenever an assessee shows exempt agricultural income in his return, the primary document to verify is the land record (For ex: 7/ 12 extract). It gives data about the cultivable, irrigated, fallow, dry land. It also tells about the crop grown and its acreage. The land may be located using Google Maps. The co-ordinates can be located by identifying a place/ structure on Google Maps. Most of the times it is difficult to locate as there is no direct mapping of the land records (in terms of Survey numbers) with geographical maps. So an Inspector may be deputed to visit the actual land and bring Google map images and location coordinate (latitude & longitude) using Google Pin.

8.2 Alternatively, a reference can be made to Bhaskaracharya Institute for Space Research and Geo-Informatics (BISAG), Ahmedabad, Gujrat by giving them the survey numbers to locate them and get it marked on the map with the size and shape of land.

8.3 These Google map images should be clearly demarcated to identify the assessee's land/s. They can then be sent to ISRO calling for historical images of these lands. For example if the assessee is claiming agricultural activity to have been performed in FY 2015–16, then ISRO may be asked to supply images of the demarcated land on the following dates:

1/ 04/ 2015

1/ 05/ 2015

1/ 06/ 2015

1/ 07/ 2015

1/ 08/ 2015

1/ 09/ 2015

1/ 10/ 2015

1/ 11/ 2015

1/ 12/ 2015

1/ 01/ 2016

1/ 02/ 2016

1/ 03/ 2016

so that the entire range of agricultural activities performed can be identified. If required, images from even earlier dates may be called for. Along with the images, the ISRO may also be requested to identify the type of activities performed on these lands, the type of crop grown, its acreage, etc. It is quite possible that ISRO may not have the images for all the dates being asked for as the image availability would depend on the position of satellite via-a-vis the land piece on the particular date. The missing gaps can be filled using Google Earth images.

8.4 Supplementary investigation: Satellite imagery can be a great exploratory tool for the onset of an investigation, especially with features such as 'Historical Imagery.' However, that in itself does not complete the investigation. It is important to keep in mind when using satellite imagery that it can only be a prognosis tool to lead you to the next step in an investigation, or a place for corroboration. In short, satellite imagery is a tool to be used together with other datasets and observations on the ground.

8.5 For example in the case of exempt agricultural income claimed, the Assessing Officer/ Investigator should further carry out the following investigations to make the case watertight:

i. Get the relevant data from District Superintendent Agriculture Officer (designations may vary from State to State) or agricultural university/ Research Institute to determine the approximate yield of that crop.

ii. Get the selling price of the agricultural produce from the markets where the assessee has claimed to sell it or APMC.

iii. Verify the capital expenditure like purchase of tractor, pumps, etc

iv. Verify the operational expenses like purchase of fertilizers, pesticides, seeds, labour, transport, etc.

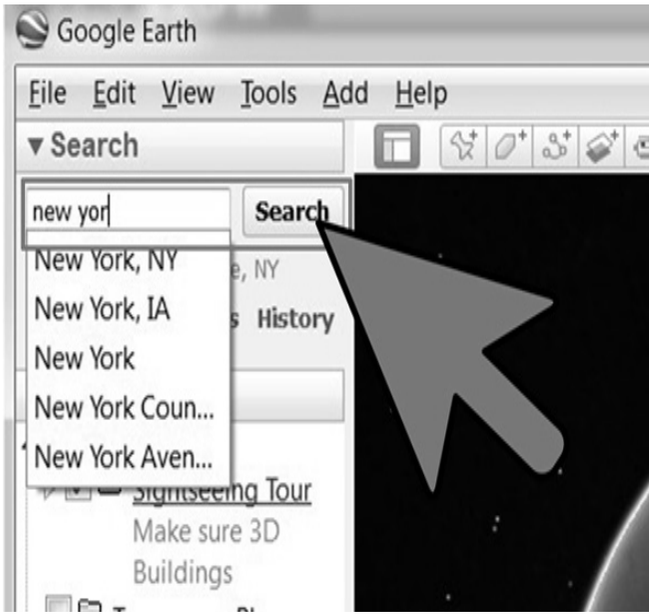
v. Record statements of the suppliers of material, transporters, purchasers of crops, market monitoring authorities, middle men, labourers, etc.

9. STEP-BY-STEP GUIDE TO USING GOOGLE EARTH

9.1 Download and install the Google Earth program from the Google Earth download page.

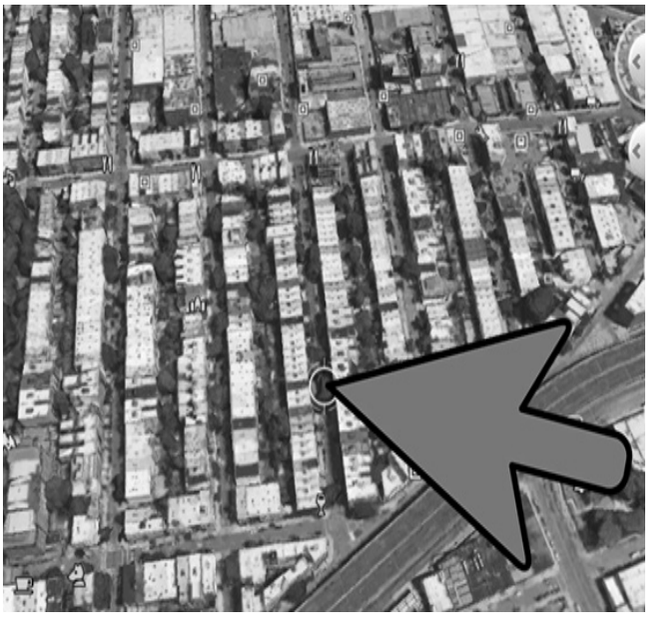
9.2 Open Google Earth once it has downloaded.

9.3 Perform searches from the search box at the top left side of the program. You can type a place name, a town/ city name, an airport or you can even try to type in a latitude-longitude location (in decimal format). Once you press the Enter key, you'll be "flown" to that destination. Try to be realistic as to things you'd actually find on a city/ State/ country map.

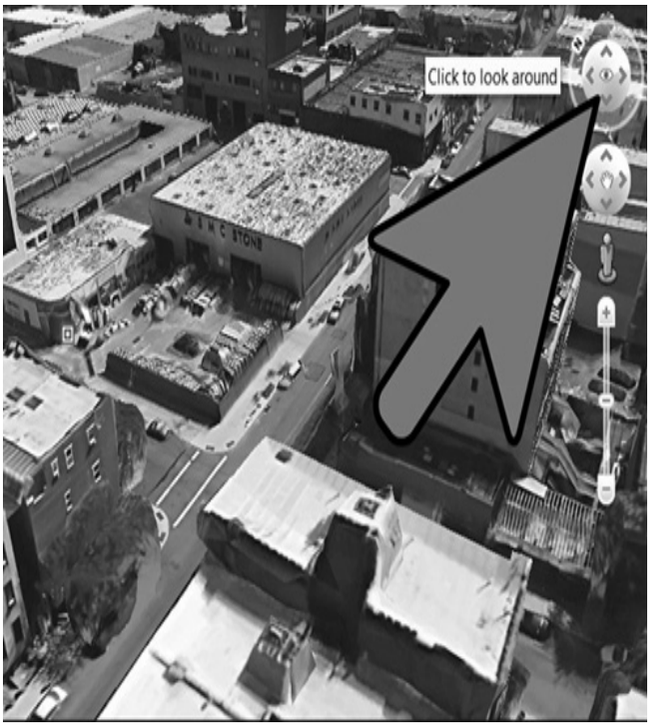


9.4 Drag the map around to move from one area to another.

9.5 Utilize the zoom out and zoom in options from the buttons on the right hand side of the screen.

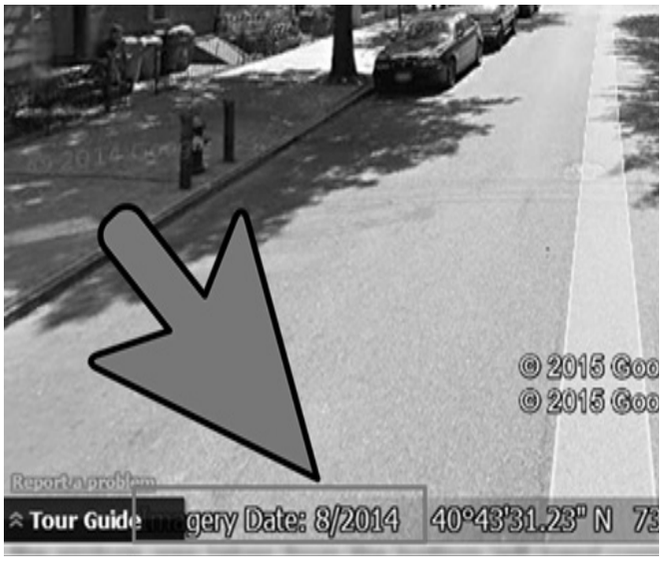


9.6 Turn the wheel in the top right corner to spin the item to a better understood angle. Change this location even more by clicking the button in the Centre of it. You can change between Land mode and views from above. Sometimes, this can be useful.

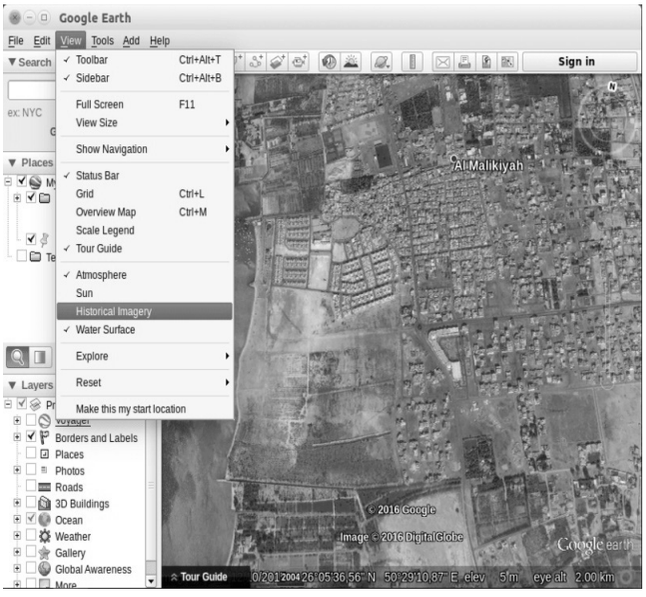


9.7 Change views. To move from an aerial view to a view as if looking from the Earth, use the horizontal bar in the right hand corner.

9.8 Look for the date the picture was taken from the bottom left hand corner of the screen. And scroll through the dates to see all the satellite images from different days of the year. Zoom to a place on the map where the satellite image has a date, click the "View" menu from the menu bar and click the "Historical Imagery" button to enable the feature. Drag the location of the toggle slider switch in the top left corner to a different date and see what the area was like.



9.9 By scrolling along the timeline of imagery we can observe changes over time. Something to be aware of when using any satellite imagery viewing platform: within a given frame of view there can be different images stitched together that actually have been taken on different dates. Sometimes it appears seamless, so that in this case you can only be sure by scrolling over the frame with the cursor and watching for a date change.



9.10 Dig Deeper

Google Earth can be a great exploratory tool for the onset of an investigation, especially with features such as 'Historical Imagery.' There are however some shortcomings. There are less ways to explore the image further, or see more metadata, as the only export file format is jpg. In traditional satellite imagery files there are different light bands to observe different elements other than RGB True-colour. For example, near infrared is often used in observing changes in vegetation or forestry. So ISRO may be specifically asked to give the images as per the requirements of the Investigation.

10. During the course of assessment use of satellite imagery technique can not only help in enquiry and investigation of the claim of the assessee but also provide un-rebuttable evidence to refute such claim and thereby strengthening the assessment so made. Some illustrations of potential use of satellite imagery in the Income-tax investigation are as follows:

S. No.	Issue	Relevant Section of the Income-tax Act/ Head
1	Claim of agriculture income exempt	Section 10(1)
2	Claim of land being used for the purposes of agriculture	Section 54B
3	Claim of any asset being claimed as not being capital in nature for claiming exemption from Capital Gain being agricultural land or located out of the municipal limit	Section 2(14)
4	Claim of investment in construction of asset made before the limitation period of 6 years	Section 147
5	Nature, extent and time of investment and subsequent changes, extension, renovation made in any immovable property	Section 69,69B
6	General wealth and living standard of the assessee	Section 69,69B,69C etc.
7	Surface mining and excavation	Unaccounted sales
8	Presence of physical stock on the surface	Stock discrepancy
9	Deployment of plant and machinery used in extraction or production of mineral oils	For computation of profit and gains under Section 44BB
10	Erection of Turnkey Power projects	For computation of profit and gains under Section 44BBB
11	Deployment of qualifying ships for operation	For computation of profit and gains under chapterXII-G

11. Under the Income-tax Act, the assessment is conducted post facto i.e. after completion of the activity. Hence, in respect of any claim of the assessee regarding any of the issues mentioned above, use of satellite imagery can be of immense help and utility to conduct enquiry and investigation by the AO in respect of any of such issues. The AO can use the historical images and their temporal progression for judging the veracity of the claim of the assessee.

12. CASE STUDIES

12.1 Cases of Land Acquisition

The assessee's had claimed that they were not required to pay any tax on capital gain on payment received towards compulsory acquisition of land and income accruing out of the payment towards non land component made under the heads construction/ structures/ Kaccha Huts/ WC/ Well/ Trees and Agriculture Crops. The CIT(A) used the satellite maps obtained from National Remote Sensing Centre (NRSC), ISRO Hyderabad to decide the claims of the assessees in appeal. As a first step, a reference was made to Bhaskaracharya Institute for Space Applications and Geo-Informatics, Gandhinagar, (BISAG) for locating and marking the survey numbers of the land acquired on the maps of Gujarat with the size and shape of the land as per the survey number. These mapped survey numbers with size and shape were sent to NRSC for obtaining the images of land as per the survey numbers along with the crops, trees, constructed structures (tube well, house, shades, etc.) to determine whether the kharif, rabi or summer crop was produced on these lands or

not; whether any construction/ structure was existing on these land during the relevant period. From the report of the NRSC, it was found that no agriculture activity or evidence of any crops were found on the impugned parcels of land for the relevant period. Only scrubs were found with no signs of any crops or vegetables and no significant construction/ structure were found on the said parcels of land. Accordingly, the CIT(A) confirmed the stand of the AO treating the consideration for land received being subject to capital gains and amount received for non land component as Income from Other Sources.

12.2 Quantum of Mining (Excavation) of Manganese Ore

The assessee holding a mining lease in Jhabua, M.P. for extraction of Manganese Ore was searched. The evidences found in search indicated that assessee had been regularly and systematically understating its actual income by grossly suppressing the actual quantity of production of Ore and also by suppressing the actual rate of sales. A survey *u/s* 133A of the Income-tax Act was conducted at the mines to determine the quantity of manganese ore physically present at the Mining area. The volumetric measurements were carried out with the assistance of the technique 'Total station'—an electronic/ optical theodolite with an electronic distance meter to read slope distances from the instrument to a particular point to determine the quantity of stock lying and the ore excavated. At the same time 3D terrestrial laser scanning coupled with satellite imagery obtained from NRSC (ISRO) was also done. In this technique, the surface of the mine of two different dates were generated using Terrestrial laser scanning technology [for current date] as well as satellite based Photogrammetry using Cartosat-I image produced from National Remote Sensing Centre (NRSC) [for a past date]. Once the two 3D digital surfaces are aligned and brought into the same space, volume difference between these two surfaces for a given area is calculated. This gave the volume of excavation done between the two dates namely, the data of Cartosat satellite image and the current date. Thus, in this case, satellite imagery was used to get historical data of the surface of mine to help ascertain the excavation or mining done in the intervening period.

13. In both the above cases, the satellite images were obtained making requisition from NRSC (ISRO), Hyderabad. In order to obtain the images the institute has to be approached with identification on map of the area in question specifying the time period and nature of information required. It is many times a time consuming exercise especially in the cases where the survey number or identification on map of the area in question is not readily available. The service of the state agencies may be required to locate the exact survey number or any other identifier on the map to be sent to ISRO for getting satellite images. However, there are many applications which provide satellite imagery online with free access such as Google Earth, Bing Maps etc. There is also an application developed by ISRO known as Bhuvan. Google Earth is copy righted whereas Bhuvan has limitation of the speed (constraint of bandwidth) and resolution.

14. The Google Earth is the most user friendly, popular and versatile application in this regard. It has all the imagery of the entire earth which has been marked based on the broad geographical divisions. It has satellite images of very high resolution ranging from 15 meters to 15 cms. Images are 2D, 3 D and there are street views of some limited locations. Images can be adjusted for sun, atmosphere and may also be superimposed with local map of the city, town or place. It also shows longitude and latitude of the place of the interest along with actual geographical surface. It also has a historical data base. The search engine can be used by input of the name of the place or its coordinates. Such applications can be readily used by the investigating officers or AOs for various intended purposes. The constraint in using the Google Earth is that it has broad mapping but for identifying a piece of land based on survey number or plot number, the same has to be superimposed with agricultural map or municipal map or any other local body map or it requires identification of some prominent landmark for exactly locating the intended place. Further, there is no regularity in time difference of two sets of historical images.

15. Despite the constraints, the Officers can very well use the satellite images which are freely accessible online on various applications for making enquiry and investigation during pre-search/ survey stage as well as while examining any claim during the course of assessment proceedings. In specific cases, services of NRSC (ISRO), Hyderabad may be requisitioned for obtaining satellite maps.

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